Inside the Mind of a VC

Avoiding A Bad Hair Day

Looking for money can be a hair-raising adventure. When startups go out to seek venture capital, the good ones have done a solid job of understanding their potential customers. The better ones have also scoped out their customer's customers. However, only the very best also view their potential investors as customers (of their stock, not their product). Yet even then, almost none seem to understand how the tone of the financial markets has impacted their customer's customer – the large financial institutions that place their money and trust in the private equity asset class, and venture capital partnerships in particular.

Gerry Langeler

Entrepreneurs often forget that venture capitalists (VCs) have to raise money, too. And the investors we call on are every bit as sophisticated, and thoughtful, and tough as entrepreneurs think we all are. Over the last year, our partnership has been out raising our sixth fund. The questions we've been asked, the decisions we've had questioned, and the veritable pounding we've taken at times reminds us all that this is not our money we are managing. It is the money of hard working people who count on our returns for their pensions, or trusts and endowments who count on us to continue their good work. So, while the subject is fresh in our minds, here are some insights into your friendly local neighborhood VC's customer.

Hair Raising Questions

We can talk all day long about our strategy, and our team, and the unique opportunities we see in the Pacific Northwest. We can describe the wealth of technology companies and infrastructure now at our disposal here. We can expound about the value-added we offer our portfolio companies, and our contacts and connections and overall wisdom. We can wave our hands about some of the substantial, lasting companies we've helped create and grow. The usual response from our customer is, "That's nice." What they really want to know is: "What are your returns?" ... or as the man said, "Show me the money!"

That question goes far beyond the basic calculations of internal rate of return (IRR) and multiple of capital invested. They want to see the detailed data: fund by fund, deal by deal, round by round. They want to know why we kept investing in a company that was obviously in trouble. They probe at bridge rounds – was it a bridge or a pier? They push us hard on the valuations we paid, "You guys appear to be seasoned, successful professionals. What were you thinking?" Of course, all these questions come with the crystal clear benefit of hindsight, in which our successes were obvious and our failures should have been equally so – at least to someone who wasn't there in the heat of battle. But in that simplicity lurks some hidden truth. Every time a venture capitalist writes a check, he or she is not just putting money on the line – a reputation is being tested. Because at some point, a few years later – they will have to answer to

not just their partnership, nor the investors in that specific fund – but potential new investors who only see the results of the decision.

Vidal Sassoon Was Right

Perhaps you recall the famous TV ad in which the Sassoon hair stylist remarks, "If you don't look good, we don't look good!" Looking bad is yet another risk to venture capitalists. We all recognize the financial risks we take in an inherently risky business. It is one reason we all build portfolios in each fund, and practice portfolio management with gusto. Now, the best way you can make a venture capitalist look good is, to quote Oakland Raiders owner Al Davis, "Just win, baby!" However, since no one knows in advance if you are going to win, here are some things you can do to keep your VC from looking bad.

"If you don't look good, we don't look good!"

First, realize that the valuation you place on your company not only has to compete against other deals in the VC pipeline, but has to stand up to scrutiny years later. For a while, VCs forgot about some basic math. To offset the high portfolio mortality rate we all live with, we need our "winners" to deliver ten times our money or better. Let's take new deal circa 1999. The market was hot, and startups were sometimes getting $20M pre-money valuations (or higher!). If a company raised $10M, the firm was now worth $30M post-money. If no additional money went in, that startup would have to be worth $300M at liquidity for the VCs to have a 10x winner. However, it was more likely that at least another $20M would go into the firm over time before an exit presented itself (ie. at least $50M post-money). That means the company would have to be worth more than $500M. Now, for a while $500M valued three-year-old companies were run of the mill. But in today's world, and in fact most times, they are very rare indeed. So, understand why VCs tear out their hair about valuation – both pre-money and post-money, and look ahead to the next round(s) even as the current round is coming together. There is a reason pre-money values for startups are back in the low to mid single digits. Everyone has gotten reintroduced to simple arithmetic.

Wearing A Hair Shirt

During the boom times, companies could run up to, or off of, the edge of the cliff on cash, assuming correctly that their VCs would be there to save them with either another equity round, or at worst a bridge note to tide them over. However, in the cold light of hindsight – many of those calls look careless, or worse. These days, do not expect your VCs to be there to bail you out if you do not manage your cash and your business so that you don't run out of money at an inconvenient time. (Hint: there is no convenient time!) We have a maxim in our partnership: when the page listing our investments in a single company gets more than three lines on it (ie. we are either up to Series D preferred, or we are starting to write repeating bridge notes) all our hair stands on end! Plan your business and your cash needs so that you raise money (finish, not start) at least six months before the till is empty. Not only will you make your VC happy, you'll end the day with every hair in place.

OVP Venture Partners is a leading technology-focused venture capital firm in the Pacific Northwest. The firm makes equity investments in early-stage companies primarily in the western third of North America, with a leading market-share position in the Pacific Northwest. OVP's emphasis is on firms in software technology infrastructure, communications infrastructure, and process solutions.

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