

Inside the Mind of a VC

The Price-Progress Paradox

Recently, there has been quite a bit of wailing and moaning and gnashing of teeth regarding an apparent dichotomy in the venture capital business. Why is it that there is so much money out there, but not many early-stage companies are being funded?



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Besides licking our collective wounds from the pummeling we've sustained the last couple of years, venture capitalists are starting to really look back as well as forward. We've analyzed what we used to do right, not just what we more recently have done wrong. We've even done the unthinkable and applied some of the same due-diligence discipline to our business models as we have inflicted on unsuspecting entrepreneurs. And we found a smoking gun!

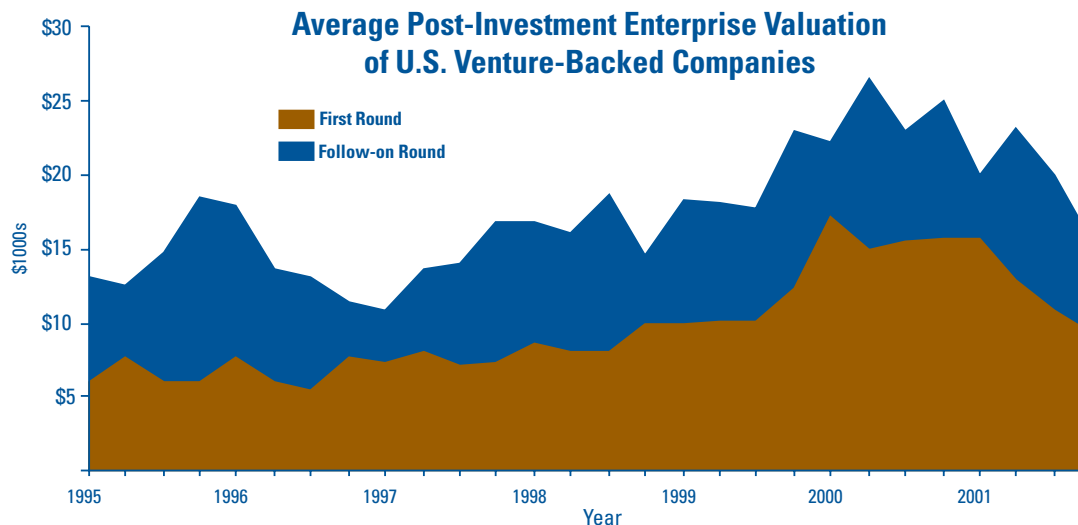
Buried in the reams of data about the venture capital business is a simple set of relationships, remarkably stable over time, that in large part explains why it seems to be harder to get VCs to jump on a Series A (first-round) deal today. It turns out that we have not been getting paid for the risk we take and the time our money is tied up.

Take a look at the graph below. It shows the average post-money valuations for first-round venture deals and follow-on deals, by

quarter, from 1995 through 2001. At first glance, your eye will be drawn to the now-familiar bubble impact of the dramatic rise in valuations and their subsequent fall. More interesting for this analysis, however, is the remarkably constant spread between them. While there is some quarter-to-quarter noise, on average the "gap" is about \$7 to \$8 million. In other words, *after the money goes in*, the average second-round deal ends up valuing a company at about \$7.5 million more than the deal was valued after the first round was completed.

Initially, you might be tempted to think that this makes perfect sense and should be a comfort to venture capitalists. Progress was being rewarded with higher prices, was it not? No, it was not! The italicized words above are there for a reason. Let's take a typical early-stage start-up as an example. Hotshot Networks has assembled a number of very credible folks who plan to address the emerging market for standard network processing hardware and software. They've written a business plan and now need cash to go into product development. They agree with their venture backers to take \$4 million in a Series A round at a \$4 million pre-money value, which equates to an \$8 million post-money valuation. So far, so good for all concerned.

A year later, Hotshot Networks has a beta



product ready, and a few beta sites signed up: a fairly typical amount of progress in a deal going well. The entrepreneurs now go out to raise their Series B round to build their sales force and scale the enterprise. They think they need about \$8 million to do so. If the chart on page 2 is correct, on average they can expect a post-money valuation in the neighborhood of \$16 million. But that equates to a pre-money valuation of \$8 million, or exactly the same as the valuation after the Series A done one year earlier! The entrepreneurs have worked their tails off for 12 months, with no up-tick in valuation to show for their efforts—a real hit to employee morale. But the VCs are even more discouraged. They took the product development risk, took the competitive risk that someone might come along over the intervening year and leapfrog the idea, and had their money tied up for a year with the IRR clock running. Yet the price per share of the stock for the Series B is going to be the same as the Series A. Great progress was made, but no price premium was realized.

If you were a venture capitalist, you would have been smarter to sit on the sidelines, let someone else do the Series A, and then come along a year later and pick and choose among the best of those now less risky deals.

So why have venture backers managed to do so well (at least until recently) in spite of this arithmetic? First of all, these are averages, and everyone knows that the venture capital business is not about hitting for average; it is about hitting home runs. A few terrific deals pay for all your sins of omission and commission. Getting in early gives you differential access to getting on that home-run team. That said, there is still something useful to be learned by both entrepreneurs and VCs from the simple math above. Capital efficiency is back.

In the scenario above, if instead of raising \$8 million in the Series B, the company

raised \$4 million at the same post-money of \$16 million, the pre-money would have been \$12 million rather than \$8 million, or a 50 percent increase from the \$8 million post-

money Series A. A 50 percent annual IRR is something to smile about, particularly these days! If Hotshot Networks could find a way (and there are many ways) to grow while not consuming as much capital, both the entrepreneurs and VCs

would come out on top, and progress would be rewarded. In fact, that's how things worked in the early 1990s, before the bubble got everyone thinking that the way to grow a successful enterprise was to throw money at it. Follow-on rounds were not automatically assumed to come in at the \$6 to \$10 million range as they have recently.

Today, smart entrepreneurs and smart venture capitalists are focusing on growing capital-efficient technology businesses. If you want to succeed in the new (or is it old?) model of start-ups and avoid the price-progress paradox, that is the way to play.

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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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