Chapter 2

VC Players

CHAPTER OUTLINE

KEY TERMS

VC firm
General partner (GP)
VC fund
Limited partner (LP)
Capital call
  = drawdown
  = takedown
Committed capital
Investment period = commitment period
Follow-on investments
Early-stage fund, late-stage fund, multistage fund
Raised, closed
Vintage year
Fund-of-funds (FOF)
Management fees
Lifetime fees
Investment capital
Invested capital, net invested capital
Carried interest = carry
Carried interest basis = carry basis
Contributed capital, net contributed capital
Priority returns
  = preferred returns
  = hurdle returns
Realized returns, unrealized returns
Catch-up provision
Clawback
Restrictive covenants
Call option

TEACHING NOTES

2.1 Firms and Funds

Students should be able to define the following terms: VC firm, general partner (GP), VC fund, limited partners (LPs), raised, capital call or drawdown or takedown, committed capital, closed, investment period or commitment period, follow-on investments, early-stage fund, late-stage fund, multistage fund, and vintage year.

A VC fund has a finite lifetime, which is typically 10 years plus optional extensions of a few years. Limited partners, mostly institutional investors, commit to providing a fixed amount of capital (committed capital). The VC charges an annual management fee over the life of the fund, which is often two percent of committed capital. Funds invest the remaining capital over the investment period: generally the first five years.

Most VC firms specialize their funds by stage, industry, and/or geography. Successful VCs raise funds every few years so that there is always at least one fund in the investment period at all times.

Staggering funds allows LPs to balance capital inflows and outflows. It also decreases the likelihood that their VC portfolio will miss out on a good vintage year. As economic environments differ across time, some years are better to start a VC fund than others.

Exhibit 2-1 provides a timeline for several funds of EarlyBird Ventures (EBV): a prototypical VC firm. This exhibit gives a feel for how VC firms space out their funds. It also allows students make conjectures about each fund's performance and corresponding investment environment.

VC firms are typically small and top-heavy. Though the backgrounds of VC professionals vary significantly, certain commonalities exist. VCs often have experience in IT or health care, a degree in science or engineering, and an MBA.

2.2 The Limited Partners

Students should be able to define the following term: fund-of-funds (FOF).

Exhibit 2-4 shows the relative prevalence of VC investment by investor class. Since 1980, pension funds have provided 44 percent of the committed capital in the VC industry, which

makes them the largest contributor by a significant margin. The other investor classes include endowments and foundations, individuals and families, corporations, and financial and insurance companies.

Fund-of-funds (FOF) represent a special type of financial intermediary that aggregates capital, mostly from wealthy individuals and small institutions, to invest in a portfolio of VC funds. By pooling their resources, FOF gives smaller investors access to a diversified portfolio of funds.

2.3 VC Partnership Agreements

Students should be able to define the following terms: management fees, lifetime fees, investment capital, realized investments, unrealized investments, cost basis, invested capital, net invested capital, carried interest or carry, carried interest basis or carry basis, priority returns or preferred returns or hurdle returns, clawback, contributed capital, net contributed capital, catch-up provision, write downs, restrictive covenants, and call option.

Management fees fund the day-to-day operations of VC firms. The most common initial fee is two percent of committed capital. Often, this fee will drop after the five-year investment period.

Students will need to know these definitions to solve the text's exercises:

- *lifetime fees* = the total amount of fees paid over the lifetime of a fund
- *investment capital* = committed capital - lifetime fees
- invested capital = cost basis for the investment capital of the fund that has already been deployed
- net invested capital = invested capital - cost basis of all exited and written-off investments

Carried interest enables GPs to participate in the profits of the fund. Variations occur in the percentage level of carried interest, the carried interest basis, the timing of the carried interest, priority returns, and clawbacks.

The level and basis of carried interest are the main determinants of the total dollar amount of GP carried interest. Most VC firms receive 20 percent carry, although top VCs may be able to charge a higher percentage. The vast majority of firms use committed capital as the carry basis. A small percentage of firms use invested capital (committed capital - management fees), which generates more carry for the GPs.

Regarding the timing of distributions, the LP-friendly method requires GPs return the whole basis the LPs before receiving carry. GP-friendly methods allow for early carry distributions.

For example, funds may require invested capital or contributed capital (invested capital + management fees paid to date) be returned to the LPs before the GPs earn any carry.

Priority return structures promise the LPs a certain rate of return before the GPs collect carry. Priority returns typically have a catch-up period. Upon reaching the priority threshold, the GPs then receive a disproportionately high ratio of the profit until the aggregate profit is split according to the chosen carry level. If there is no catch-up period, the priority return provision will permanently affect the aggregate profit split.

A fund with an early carry distribution rule experiencing declining performance may initially exceed the carry threshold and subsequently drop closer to or below it. Such a situation causes the aggregate carry earned by GPs to fall. Clawback provisions allow LPs to recoup the previously distributed carry.

To better align incentives, LPs often restrict GP behavior with covenants written into the partnership agreement. Gompers and Lerner (1996) break restrictive covenants down into the following categories: covenants relating to the management of the fund, covenants relating to the activities of the general partners, and covenants relating to the types of investment.

Appendices: Key Terms and Conditions

Appendix 2.A-C gives excerpts from the private placement memorandum for three (fictional) VC funds.

The fund durations (also called terms), commitment periods, and general partner clawback obligations are the same across all three funds and representative of industry norms.

Owl Ventures IX employs a different management fee structure than the other two funds. The fund's percentage fee changes depending on the fund's year. Notably, the management fees start declining following the initial investment period (the most common structure).

Distributions vary across all three funds. Talltree Ventures IV exhibits the most complex structure. The fund has a priority return and catch-up provision. All three funds require the return of contributed capital, which allows for early carry distribution.

SUGGESTED ANSWERS TO EXERCISES

2.1 Suppose that a $200M VC fund has a management fee of 2.5 percent per year for the first five years, with a reduction of 0.25 percent (25 basis points) in each year thereafter. All fees are paid on committed

capital, and the fund has a ten-year life. What are the lifetime fees and investment capital for this fund?

Lifetime Fees = $42.5
Investment Capital = $157.5

Please see Excel Solutions for the full, worked solution to this exercise.

2.2 (This is a little bit tricky.) Suppose that a $1000M VC fund has fees of 2.0 percent per year in all years, with these fees paid on committed capital in the first five years and on *net invested* capital for years 6 through 10. You can assume the fund is fully invested by the beginning of year 6, and then realizes 20 percent of its investment capital in each of the following five years. What are the lifetime fees and investment capital for this fund? (Make assumptions for any information that you think is still missing from the problem.)

Lifetime Fees = $150.94
Investment Capital = $849.06

Please see Excel Solutions for the full, worked solution to this exercise.

2.3 A VC firm is considering two different structures for its new $250M fund. Both structures would have management fees of 2 percent per year (on committed capital) for all ten years. Under Structure I, the fund would receive an X percent carry with a basis of all committed capital. Under Structure II, the fund would receive a Y percent carry with a basis of all investment capital. For a given amount of (total) exit proceeds = $Z, solve for the amount of carried interest under both structures.

Carried Interest under Structure 1 = X% * (Z - 250)
Carried Interest under Structure 2 = Y% * (Z - 200)

Please see Excel Solutions for the full, worked solution to this exercise.

2.4 Talltree Ventures has raised their $250M fund, Talltree Ventures IV, with terms as given in Appendix 2.B of this chapter. Construct an example of fund performance where the clawback provision would be triggered. In this example, compute the carried interest paid in each year, and show the total amount that must be paid back by the GPs upon the liquidation of the fund.

Answers may vary

Please see Excel Solutions for the full, worked solution to this exercise.

