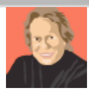

Al Waxman

A VC Model for the New Economy: "Back to the Future"

Posted on: August 14th, 2009

There has been considerable concern about the performance of venture capital as an asset class, and about the just-beginning VC industry shakeout. What has become evident is that much of the venture industry has lost its way and must return to its decades-old roots to become successful again.

Venture capital returns in the first decade of the 21st century have been poor. Early in the decade, there was the ferocious dotcom bubble which, when it burst, decimated the returns of venture firms most invested heavily in that sector. However, the investment activities that emerged during the bubble led to a persistent, but ultimately untenable venture capital model, which still characterizes much of what we see in venture capital practice today.

During the bubble period, the capital needed for companies to reach key valuation milestones grew exponentially and without discipline. As limited partners raced to put money to work in the VC asset class, venture funds deployed large amounts of capital into too many startups. Too many funds became generalists with partners on the boards of far too many companies. There emerged an overabundance of "me-too" deals, misaligned investor syndicates and disengaged board members. Rapid exit often became the focus of investors and management alike, rather than the reward for building a profitable company of great value.

The venture industry lost its focus on the original purpose of providing capital for growth, profitability and sustainability and replaced it with a focus on early exit (M&A or IPO). The result has been called a failure of venture capital. In reality, it is a failure to honor the tried and true principles of effective venture capital. What, during the dotcom bubble, appeared to be an easy asset class in which to make money, turned out to be not so easy after all, requiring highly refined skills around investment selection, development and management.

So can you make money in venture capital? The answer is definitely, yes. There will be fewer venture firms, but those that succeed will do so by returning to the proven investment principles that served the industry well up to the emergence of the dotcom bubble. Specifically, successful venture firms will regain their focus on specific industry sectors and cultivate relevant industry expertise. They will invest in startups with a clear path to profitability within a five-year time frame and invest only in companies that have a proven concept and viable business model—companies at an earlier stage than this are generally better funded by angels and old-fashioned bootstrapping.

As in the earlier days of venture capital, companies will have a true lead investor which controls the majority of senior securities and which reserves investment capital to support the company's entire life cycle. Where there is an investment syndicate, it will be small and comprised of investment allies whose time horizons, philosophies and expertise are synergistic with the lead investor. GPs will truly be partners with start-up management in financial and strategic matters and both will operate in the framework of a coherent Board of Directors where incentives are aligned. This is key to ensuring that exits occur when value is optimized, rather than under stress.

The best venture firms will have a lofty goal – zero failures — that will help insure relentless attention and focus. This is a strong contrast to the now accepted concept of a "portfolio" approach, where it is generally accepted that

2-3 exits can make up for the failures of the rest of the portfolio.

The on-going evolution of the venture industry says much about the evolution of American business itself. It typically starts small, winners prosper and grow, and more players are attracted to the particular industry. Too often, the essential ingredients for success get lost amid accelerating growth and, inevitably, many players falter. The good news is that American business is resilient. It has the ability to recognize mistakes, adjust, and return to viability. The tools for this transition in venture capital are known and thus the opportunity is great. In a time where venture capital holds a key role in catalyzing the innovation our economy needs to grow, this is a call to action to ensure our industry prospers to deliver on that promise.

Al Waxman is a Senior Managing Member and CEO of Psilos. Dr. Waxman also is chairman and/or a director of several Psilos companies including: Click4Care, HealthEdge, CareGuide, Inc., Quality Metric, Extend Health and Mauna Kea. He is also on the Board of Cenegenics (a non-Psilos investment).

In addition to his current Psilos responsibilities, Dr. Waxman serves as a Commissioner of Healthcare for the State of New Mexico and as President of the Center for Contemporary Arts in Santa Fe.

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6 Responses to "A VC Model for the New Economy: "Back to the Future""

1. *Kevin* Says:
   August 14th, 2009 at 2:27 pm

   Al-

   It is my hope that the goals that you outline above will become part of a new reality in the VC world. Too many firms have lost focus of core business principles and have instead veered into the unsustainable path of the modern day gold rush. I believe VC firms will be crucial in helping to bring America out of the current recession by funding and cultivating "nuts n' bolts" businesses that will hopefully bring jobs and prosperity to this proud country.

   Kevin

2.  *JPM* Says:
   August 17th, 2009 at 1:28 am

   I agree that in the euphoria of vc and pe firms making tonnes of money - it attracted a lot of second rate (for lack of better words) individuals and firms. Lofty goals such as zero failure are good on paper… but great VCs know that its not practical and hence the need for a portfolio. Yes, we try to increase our hits - but that partly revolves around how the VC manages the portfolio company.

   I think what ppl fail to recognize is that VC money is money being put to use, side effects are called 'employment' (which btw is falling in US!) When a company burns through a whole pile of money, the only good thing is that they tried and failed. And failure is good. We're just waxing the wheels of capitalism.

   If we aimed at zero failure, we wouldnt be making any investments because our deal evaluation would be extremely tight.

3. *Jim Freidell* Says:
   August 17th, 2009 at 10:50 am

   Al,

   IMHO, VC must return to the tried and proven practices of the 1980s and early 1990s. That means that VC partners without actual C-Level experience actually building companies to IPO exit need themselves to exit the VC industry (or at least accept associate positions) to make room for partners that KNOW by actual experience what it takes to build billion-dollar home runs through liquidity/exit via IPO and delivering 60% compound annual ROI to investors. VC funds must also deal with the realities of 9.5+ years from initial startup funding to highly successful IPO exit. There are startups out there that can provide the 60% annual ROI for 10 years. And there crtainly are LPs out there that want to put their money to work for longer than 10 years. VC GPs must come in line with current realities or go Bye Bye.

4. *Yuri Ammosov* Says:

August 18th, 2009 at 5:12 am

In the U.S., one can hold a public office and be a CEO of a private company in the same field???

5. Al Waxman Says:
September 14th, 2009 at 4:48 pm

Jim, I agree with your view.

6. Al Waxman Says:
September 14th, 2009 at 4:54 pm

JPM: I think a VC firm has a responsibility to manage its investors money to provide returns that are commensurate with the risk. Clearly venture capital is a means to drive new business and create employment but the purpose of VC investment is not to do that. Our goal of zero failure doesn't mean you won't ever have a failed portfolio company, but it does mean we won't invest in companies that don't have valid business concepts. That goal also means that we don't quickly abandon ideas when times get rough and we make every effort to guide the portfolio company back towards success.

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