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Author
Kenney, Martin

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Note on “Venture Capital”

Martin Kenney

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Martin Kenney is Professor, Department of Human and Community Development, University of California, Davis and Senior Project Director, BRIE, University of California, Berkeley.

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1. Venture Capital

Apparently, "venture capital" was first used as a term in a public forum by Jean Witter in his presidential address to the 1939 Investment Bankers Association of America convention (Reiner, 1989). Since then venture capital has evolved into a specialized form of finance supporting small privately owned companies judged to have the potential for fast growth. With few exceptions, the overriding goal of venture capitalists is to reap capital gains in excess of ten times their original investment in less than seven years. A most strict definition of venture capital excludes buyouts, loans, and other financial transactions. Venture capitalists invest in equity in the form of common stock, or preferred stock, convertible debentures, or other financial instruments convertible into common stock when the small company is sold either through a merger or a public equity offering. At this liquidity event venture capitalists realize their profits in the form of capital gains.

2. The Venture Capital Industry

During the last 50 years a number of the fastest growing firms, particularly in the technology area, in the U.S. economy received venture capital. These include Amazon.com, America Online, Amgen, Apple Computer, Cisco Systems, Compaq, DEC, Federal Express, Genentech, Intel, Lotus, Netscape, Oracle, Seagate, Sun Microsystems, 3Com, Yahoo!, and countless others. These and other venture capital-supported firms were responsible for the establishment of entirely new industries such as biotechnology, semiconductors, database software, the Internet, hard disk drives, minicomputers, workstations, and data communications. In this way venture capital became an important part of the U.S. national system of innovation.

Since the emergence of formal venture capital organizations there has been significant institutional experimentation seeking the best format to support venture investing. Not surprisingly, the organizational forms have varied through time. Though the independent private venture capital firm is the dominant organizational form, it is not the only one. Financial institutions particularly banks using their small business investment corporations (see below) also have been significant participants since the early 1960s. Industrial corporations have had significant venture capital operations since the mid-1960s. There have also been other formats including publicity-traded closed-end funds, other publicly traded vehicles, and family funds. In the early 1980s the private firms became the dominant format for venture investing. In the private firm the venture capitalists manage the limited partnership funds, each of which was denoted by a Roman numeral in increasing order. In these funds the venture capitalists were the general partners and investors were the limited partners. The investors included pension funds, foundations, endowments, corporations, wealthy individuals, and various other entities. The duration of a particular fund was typically between seven and ten years. During the first one to three years the fund actively invests, then in the final years the fund harvests its investments.

Compensation for the general partners has two components. The first component is an annual management fee paid by the limited partners; this can range from two to three percent of the limited partner's investment. These fees pay the costs of operating the firm and the salaries of the all employees including the venture capitalists. Very often, successful firms have two or more funds operating simultaneously, all of which provide management fees. The other component is the carried interest, which refers to the percentage of the capital gains the venture capitalists retain from the investments after reimbursing the initial investment of the limited

partners. The carried interest varies by fund from 20 to 30 percent of the total returns. In the case of successful fund this can be very large.

3. History

Venture capital investing has always been cyclical, and largely governed by the receptivity of the stock market to new stock offerings. And yet, since the inception of formal venture capital investing in 1946 there has been a continuing growth in the amount of venture capital available. In 1965 venture capitalists invested less than $100 million in new ventures. In 1999 investments had increased to $48 billion (Venture Economics).

For centuries, wealthy individuals have invested in risky ventures in the hopes of securing an outsize return. Such investments can be traced back at least as far as the involvement of merchants in organizing consortia to finance long-distance trading ventures. The financing for firms participating in the Industrial Revolution came from merchants and other wealthy individuals willing to back entrepreneurs building manufacturing facilities or exploiting a new technology. These informal investors are now known as "angels," i.e. individuals who are not professional investors in startups.

During the 1930's in both the U.S. and the U.K. there were discussions of the lack of investment capital for small businesses. In the U.K. the 1931 Macmillan Report identified a shortage of private sector funds for supporting small business. The report contributed to a contemporaneous debate in the U.S. about how to provide funds for the small businesses severely affected by the Great Depression. There was little agreement about what types of small businesses should receive funding and the proper vehicles for providing financing.

Prior to World War Two, there were a few wealthy families, such as the Mellons, Phipps, Rockefellers, and Whitneys, investing in young ventures. Shortly after World War Two in New York City these families established offices and hired professional managers to discover, evaluate, and invest in small companies with superior growth prospects. These were the first family venture capital funds. Though each of them changed many of their organizational characteristics, the Rockefeller (Venrock), Whitney (J.H. Whitney), and Phipps (Bessemer Ventures) funds continued to be active in 2000.

The other significant private sector initiative was the establishment of American Research and Development (ARD) in Boston in 1946. ARD was important, not only because of the firms it funded, but also because of the Harvard Business School (HBS) faculty member, General Georges Doriot, who established it. Doriot influenced a number of HBS students who later became venture capitalists. As important, Doriot through his writing, speaking, and example defined many of the practices of venture investing. Finally, ARD's $70,000 investment in Digital Equipment Corporation in 1958 was worth $350 million in 1971 – ample proof that significant return was possible.

The role of the U.S. Government in the development of venture capital has been limited with a few important exceptions. In 1958 the U.S. government passed legislation creating the Small Business Investment Corporations (SBICs) to encourage investment in small businesses. Despite being plagued by abuse during its first decade, the SBIC program made two important contributions to the development of the industry: The first contribution was its loan guarantees, which permitted participants to leverage their private funds. This made low-cost capital available to investors, a number of whom soon left the SBIC program and established important independent venture capital firms. The SBIC Act also loosened Depression-era laws forbidding

banks from owning more than 5 percent equity in any company. By having an SBIC the banks were permitted to own large equity stakes in their venture-type investments. Particularly in the 1960s and 1970s banks were a significant source of venture capital. During the 1980s the independent firms displaced them.

There was other Federal legislation, which had a significant impact on venture capital. The most important was a series of changes in employee pension fund laws during the 1970s. The first change was dramatic tightening by the Employment Retirement Investment Security Act of 1974, which operated to nearly cut of pension fund investment in venture capital. The legislation was gradually loosened from 1977 through 1982 and new pension fund monies flooded into the independent firms. Lowering capital gains tax rates, through increasing encouraged venture investing (Bygrave and Timmons 1992). With these exceptions the federal government has only had a limited role in the creating the industry.

4. Investment Process

Venture capitalists are not passive investors. Because of their equity stake, they have an interest in the firm's success, which is defined in terms of a rapid increase in the firm's value. Invariably, one or more venture capitalists "lead investors" join the firm's board of directors. From this position they actively monitor the firm's progress. However, they do more than monitor. They often assist and counsel management. This involvement comes in many forms and is situationally dependent, but includes counseling on major strategic decisions, assisting in recruiting key personnel, providing contacts in the legal, investment banking, and other business service communities. Finally, the investment by a prestigious venture capital firm creates the

perception that the small firm will be a success; an important asset for convincing customers and suppliers that the startup is viable and worthy of patronage.

Entrpreneurship depends on the structure of investment opportunities, in the typical venture capital investment scenario an entrepreneur or entrepreneurial team approaches a venture capitalist with a business plan describing the firm, the management team, potential competitors, and the market (Martinelli 1994). Since venture capitalists receive hundreds of business plans per annum, though most receive at least a cursory examination, the plans recommended by someone the venture capitalist knows receive the greatest attention. If one of the venture capitalists is interested, then the entrepreneurial team is invited to present its business plan in person. Should the venture capitalist's interest continue, the entrepreneurs' references and others who might be able to speak to the candidate's qualifications, personal and technical, are contacted. If there are technological unknowns the venture capitalist gathers information on the project's feasibility from technical experts. They also interview prospective customers trying to gauge their need or desire for the product. In other words, they gather as much information as possible about the investment and its growth potential.

If these hurdles are surmounted, then the team is invited to present the plan to a meeting of all of the partners. Should the partners agree, then a contract detailing the terms of an offer is extended to the entrepreneurs. Upon acceptance the venture capitalist invests the firm. With this investment the relationship between the entrepreneur changes as the venture capitalist now is committed to the success of the firm.

Venture capital investments are staged, and, if the firm meets preset milestones, then it receives new investments at a higher valuation. Should the firm not meet its targets or the market change at the next stage the firm's valuation can decrease. Usually, venture capitalists

syndicate their investments with other venture capitalists, thereby spreading risk, providing multiple contacts and sources of advice for the startup firm, and a cross-check on the investment decision (Gompers and Lerner 1999). There are three exit strategies for venture investments: sale of the stock through an initial public offering, sale of the firm through a merger, or bankruptcy. Upon any of these liquidity events the proceeds are returned to the limited partners as either cash or marketable securities. As a rule of thumb, three or four investments are expected to fail at a near total loss. Another three of four neither fail nor are easily liquidated. These are termed the "living dead" and are judged failures by the venture capitalists. For the successful funds it is the final two or three that determine the return. In these cases one or two investments provide returns of ten to over one hundred times the initial investment. It is these successes that compensate for the failures and complete the venture capital cycle.

5. The Globalization of Venture Capital

Venture capital as a formal institution was an U.S. innovation. In other countries and other historical periods, merchant banks, governmental bodies, and even family networks performed some similar functions, especially in regards to money raising. Beginning in the late 1970s a few of the U.S. funds looked abroad for funding opportunities. Also, in other countries governments, financial institutions, and individuals wishing to reproduce the U.S. experience established funds targeting local opportunities. Most of these non-U.S. efforts floundered because of a dearth of entrepreneurs, an inadequate institutional infrastructure to nurture and support entrepreneurship, and a lack of experienced venture capitalists. As a result, if these venture capital operations survived, it was, with only a few exceptions, by becoming what in the U.S. would be called private equity capital firms concentrating upon management buyouts,

bridge financing, purchase of equity in the stock market, and an occasional startup. The exceptions were a few firms in the United Kingdom, and notably, Israel, which became a center of venture capital-financed startups in the 1990s. In the late 1990s, due to the new opportunities for new firm formation to exploit the Internet, there was a proliferation of venture capital firms in, not only Europe, but also Latin America and Asia.

The impressive returns achieved by U.S. venture capitalists attracted investors from around the world. In some cases, these funds were routed through venture capital firms based in the U.S. and managed by foreign professionals or corporate venture capital investment operations operated by foreign multinationals. More frequently, European and Asian funds were invested in U.S. funds and invested in U.S. startups. Despite these investments, non-U.S. capital has only played a minor role in financing U.S. venture capital.

6. Conclusion

There are continuing debates regarding the efficacy of a venture capital-based innovation system. There have been recurring criticisms of venture capitalists for encouraging the exodus of high-level managers and even entire research teams from existing firms thereby disrupting product development teams (Florida and Kenney 1990). In Europe some have seen in venture capital the harbinger of rampant individualism and greater income inequality and social differentiation. The emphasis on large capital gains is thought by some to bias the economic system against incremental process innovation and large-scale systems innovation such as, for example, in transportation systems. Despite these concerns, venture capital as an institution for supporting innovation has experienced a pattern of cyclical, but massive secular growth during the past six decades.

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