

Venture Capital 101

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Private Funds

- * Hedge Funds, Private Equity Funds, and other types of pooled investment funds excluded from the definition of “Investment Company” under the 1940 Investment Advisers Act.
- * Dodd-Frank Act of 2010 changed exemptions, but in general, a fund that does not publicly offer its securities and has less than \$150MM AUM is exempt from registration with the SEC as a broker-dealer.

Accredited Investors

- * Venture Capital funds sell interests in “Private Transactions” that do not involve a public offering and are exempt from registration under the Securities Act of 1933.
- * Generally, offering will not be considered a “Public Offering” if the investment manager does not advertise the offering or actively solicit investors, and the offering is restricted to a small number of financially sophisticated offerees, termed Accredited “Reg. D Investors.”

Regulation D

- * Regulation D under the 1933 Act is a regulatory safe harbor when offering Limited Partnership interests.
- * A VC fund will not have to register its interests under the 1933 Act, register itself as an investment company under the 1940 Act, or file reports under the 1934 Act if it limits the number and types of investors:
 1. Up to 100 investors, no more than 35 non-accredited.
 2. Net worth \$1MM or \$200K (\$300K) annual income.

Carried Interest

- * Most VC equity funds are structured as limited partnerships or open-ended corporate structures (evergreen funds). Most institutional investors are tax exempt; hence, LPs.
- * As the fund's general partner, venture capital managers commonly earn "2-and-20": 2% of invested capital as a fixed annual fee and a "Carried Interest" of 20% of fund's income.
- * Part of the fund's income may consist of ordinary interest; however, a large portion of the carry consists of long-term capital gains and qualified dividends taxed (2012) at 15%

Carried Interest Misconception

- * If VCs receive capital gains and dividends as compensation for working, and carried interest is compensation for labor, shouldn't carried interest be taxed at ordinary income rate?
- * Carry is an agreement among partners to allow one partner (VC) to share in the partnership's profit in a percentage that is disproportionate to its percentage of contributed capital.
- * Internal Revenue Code section 702(b) applies throughout the economy: Partnership agreement may allocate income and expenses in any desired manner.

Carried Interest Reality

- * Venture capitalists earn carried interest as compensation for adding value. When a VC earns carried interest, it is because they worked side-by-side with an entrepreneur to build a successful business that did not exist before. If the business is not successful, then (unlike regular pay), the VC receives no carried interest.
- * Limited partners want VCs to receive carry reward only in the long-term when a company exit brings economic value to the team—entrepreneurs, investors, and VCs.

Use Capital Once And Return It

- * Institutional venture investors typically don't advance all committed capital at once to a fund. As VC fund manager makes investments, they make “capital calls” or “drawdowns” on the investors to advance more capital.
- * VCs don't hold much cash. Funds are invested once; when there is an exit, the fund distributes all proceeds less the carry (20% performance fee) and expenses back to LPs.
- * VCs can't afford low-/medium-risk investments. Rather than 3-5x ROI in 3 years, VCs seek 10x+ over 7-10 years.

The J-Curve Effect

- * “Lemons ripen faster than plums.” High-risk, high-return investments result in significant early capital losses.
- * Limited partnership structure allows the fund to transfer early costs and losses directly back to the investors.
- * Cumulative Net Cash Flow (CNCF) follows letter “J” shape—declining in early years of the fund before increasing and turning positive. Total contributions > total distributions until apx. year 5 (of 7-10).
- * Return on Investment (ROI) could be only 100% after 3 years for a fund with eventual 2x contributed capital return.

J-Curve Factors

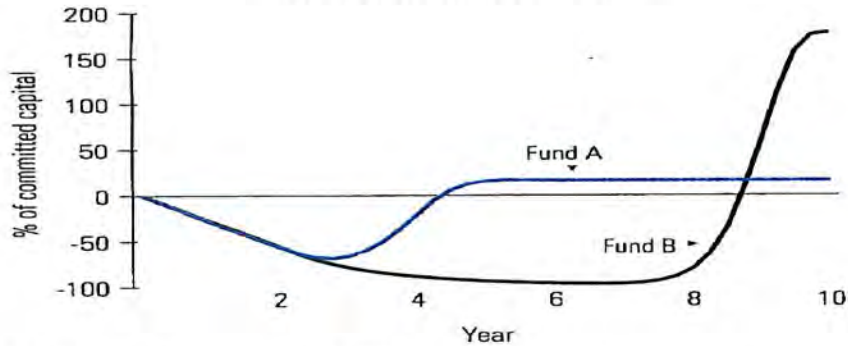
- * Many factors contribute to the shape of J-Curve:
 1. Returns on underlying investments; however, returns don't contribute to significantly different J-Curves until 4-5 years into the fund. CNCF is affected by drawdowns early in the fund's life; IRR is dominated by management fees. Apparent early returns are often poor indicator of actual performance of underlying investments.
 2. GPs accounting methodology: investments held at cost or marked to fair market value (FMV) affects IRR and ROI.
 3. Longer GP holds investment (duration) the lengthier the Cumulative Net Cash Flow curve; the flatter the IRR curve.

Mitigating the J-Curve

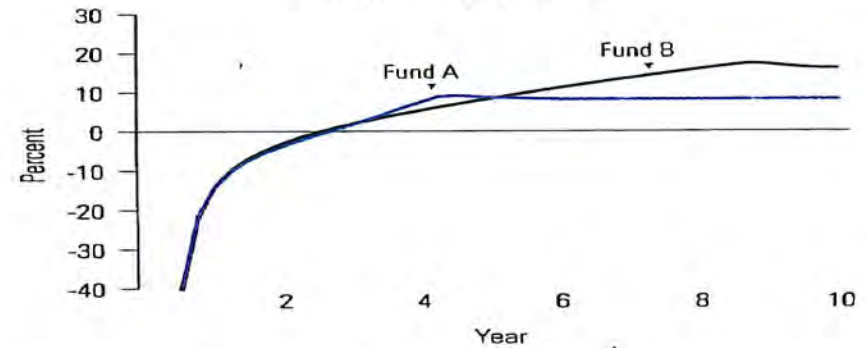
- * It is not unusual for GPs to take several years to find a sufficient number of attractive opportunities to invest all their capital. Also, funds will make subsequent investments in portfolio companies to help them expand.
- * GPs may reduce J-Curve volatility by following disciplined approach making steady, annual commitments that create a portfolio of diversified investment exits, moderating exposure to a large bad investment made in a single year.

Mitigating the J-Curve

Cumulative Net Cash Flow



Internal Rate of Return



For illustrative purposes only. Simulated performance results do not reflect actual trading and have inherent limitations. Please see additional disclosures.
Source: GSAM

VCOOC

- * VC funds establish subsidiary VCOOCs to receive exemption from DOL rules that would otherwise constrain ERISA retirement plan investments.
- * An "operating company" is primarily engaged in the production or sale of a product or service other than the investment of capital.
- * Deemed a VCOOC if (1) at some time during the FY at least fifty percent of its assets (valued at cost) are invested in "venture capital investments," and (2) in each year the VCOOC has and exercises "management rights" with respect to at least one fund portfolio company.

Questions?