UC Berkeley, Jacobs Institute April 3, 2024

Understanding Venture Capital

Mark Johnson | Dubberly Design Office

Venture Capital (VC) can mean many things.

Venture Capitalist (a VC)
the partner

manages →

Venture Capital Firm
the business

creates →

Venture Capital Fund
the limited partnership

invests →

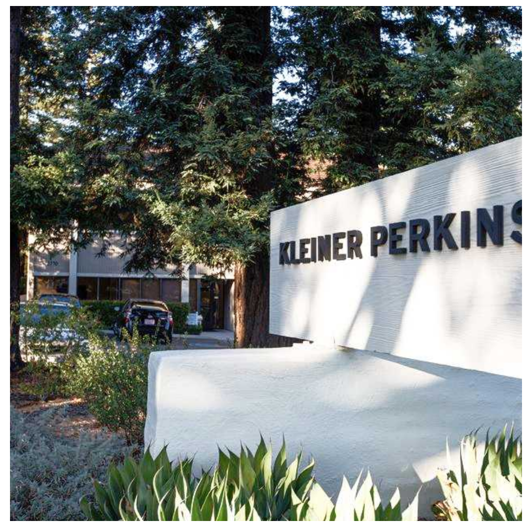
Venture Capital
the money

in →

Startups
the investment

John Doerr
General Partner

of



Kleiner Perkins
VC Firm in Menlo Park, CA

created

Digital Growth Fund

a Fund
such as their Digital Growth Fund

which invested

$11.8 million

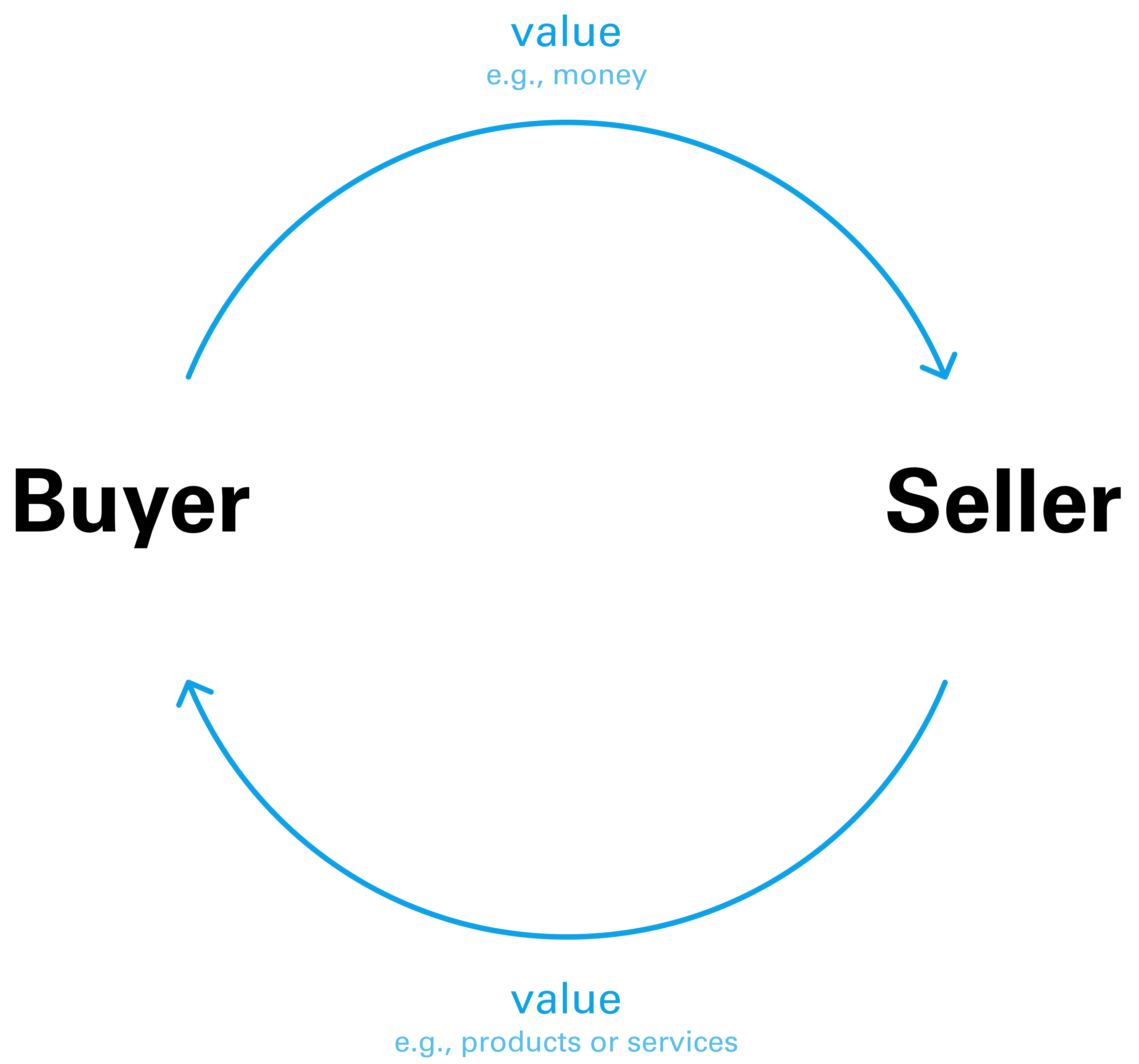
for ~10% of

Google
when it was starting up in 1999

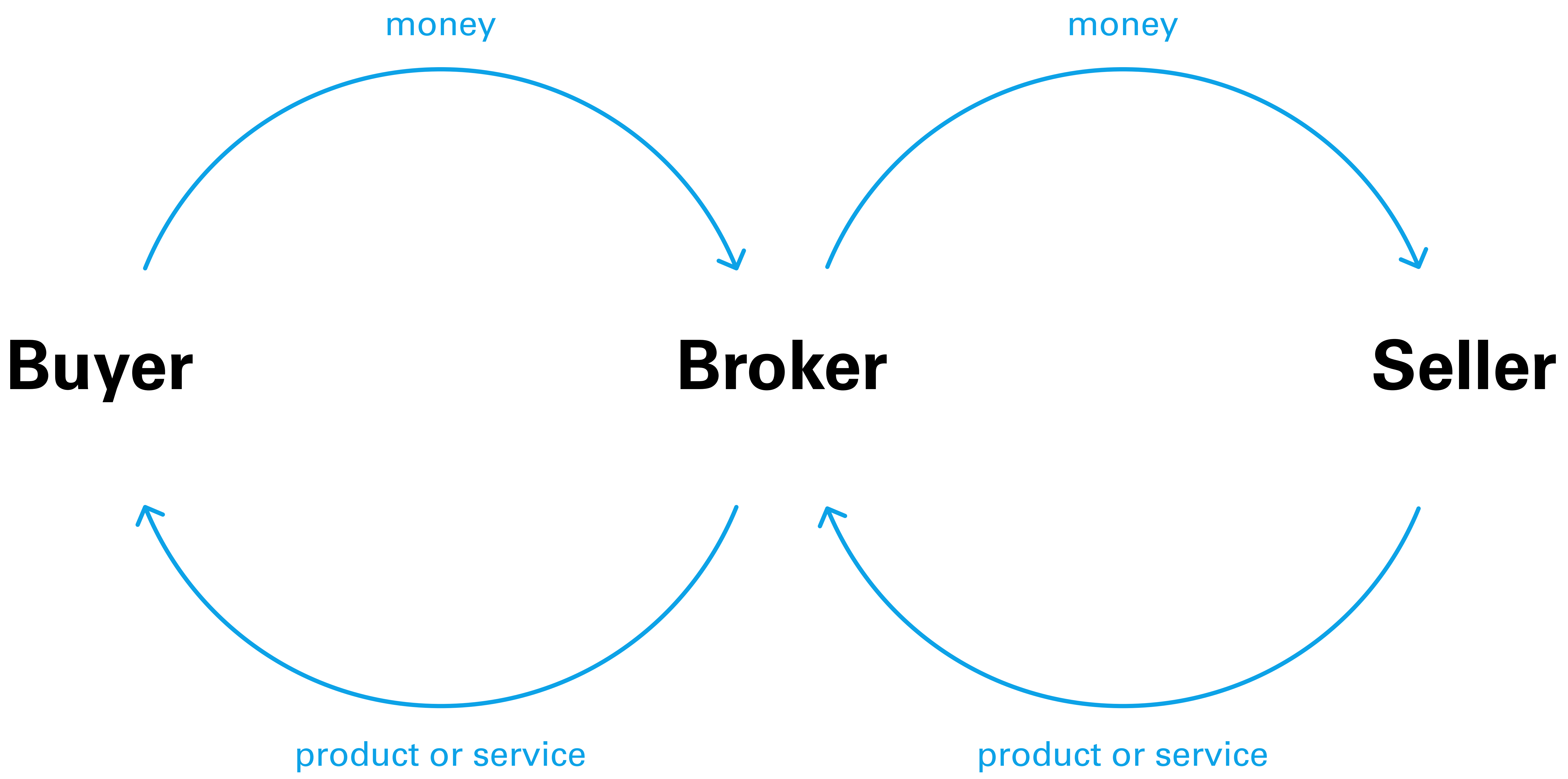
PART ONE

Introducing models of the Venture Capital system

At the heart of every business are transactions.
Two parties exchange value, typically money for products or services.

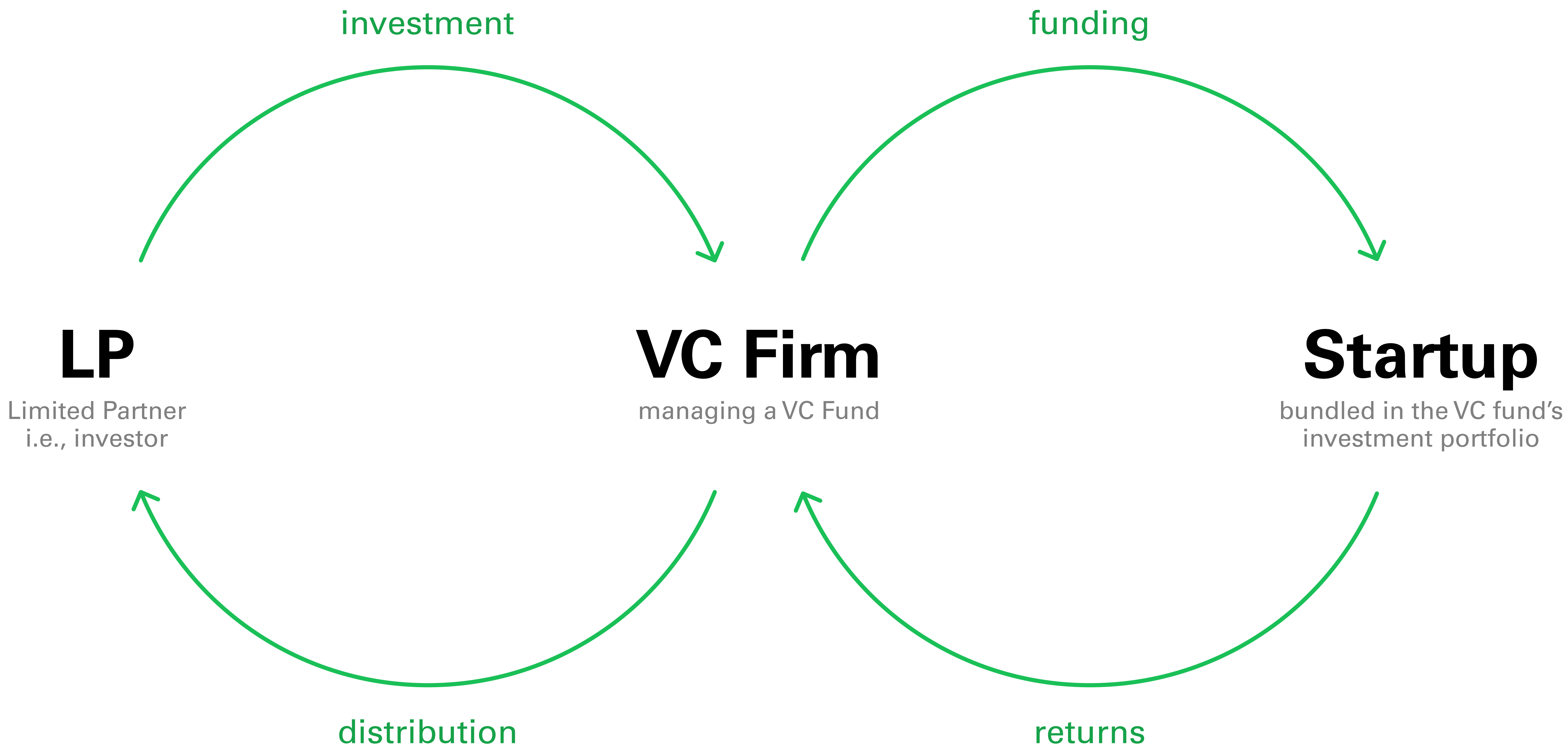


**Some markets involve a brokerage structure:
a broker acts as an intermediary between buyers and sellers.**

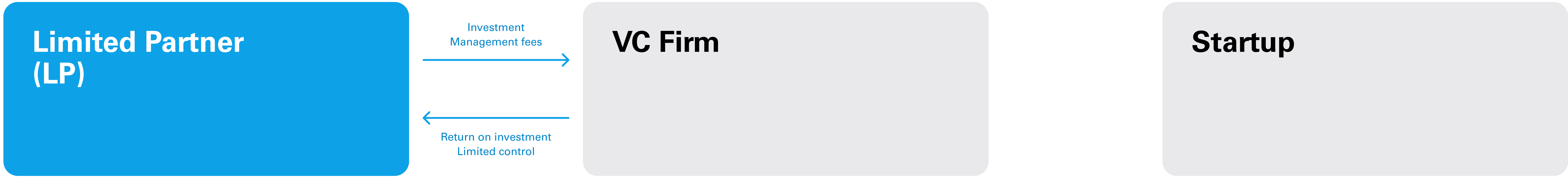


Venture Capital involves a similar overall structure in which a VC Firm acts as an intermediary party between investors (limited partners) and startups.

More specifically, LPs don't typically invest in individual startups — they invest in the fund's investment portfolio, which includes multiple startups.



How the VC system works:
The role of the Limited Partner



Investors in a VC Fund become Limited Partners (LPs).

Their liability is limited to the amount they invest.
They're also limited in their control over the VC Fund.

LPs are the VC Fund's source of capital.
LPs also pay management fees to the VC Fund.

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VCs set-up and manage Funds, which invest in Startups.

In exchange for capital, Funds receive shares in a Startup.
That is, the Fund buys a percentage of the Startup.

The Fund may also receive a seat on the Startup's board,
and with that comes a say in managing the Startup.

How the VC system works:
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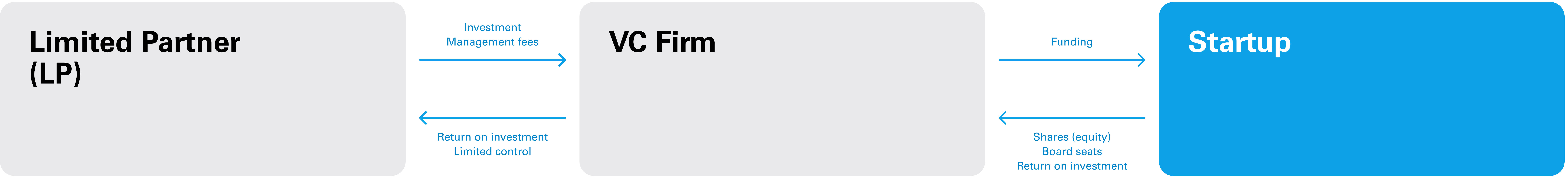

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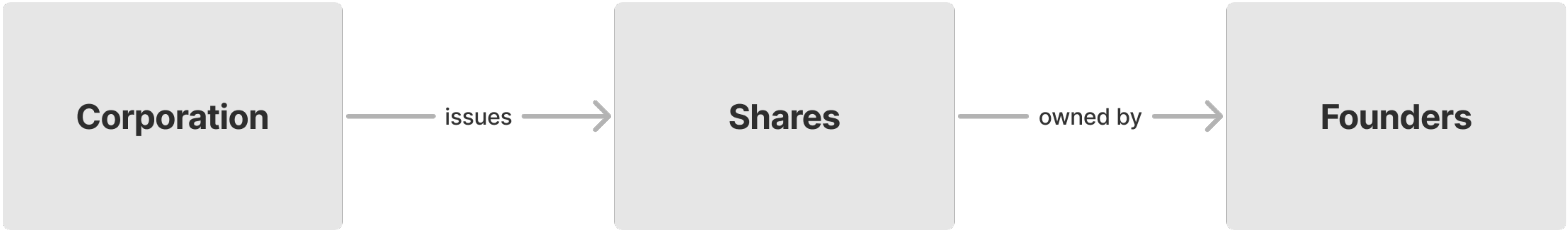
The Startup uses the capital to pay for development, which, hopefully, leads to growth in customers and revenue.

If things go very well, the startup has a liquidity event (either an IPO or direct sale),
and the VC Fund sells its shares at a substantial profit, most of which goes back to the LPs.

The Startup's perspective

The goal is to create value for society
by finding product-market fit
in order to generate profit
in order to increase shareholder value.

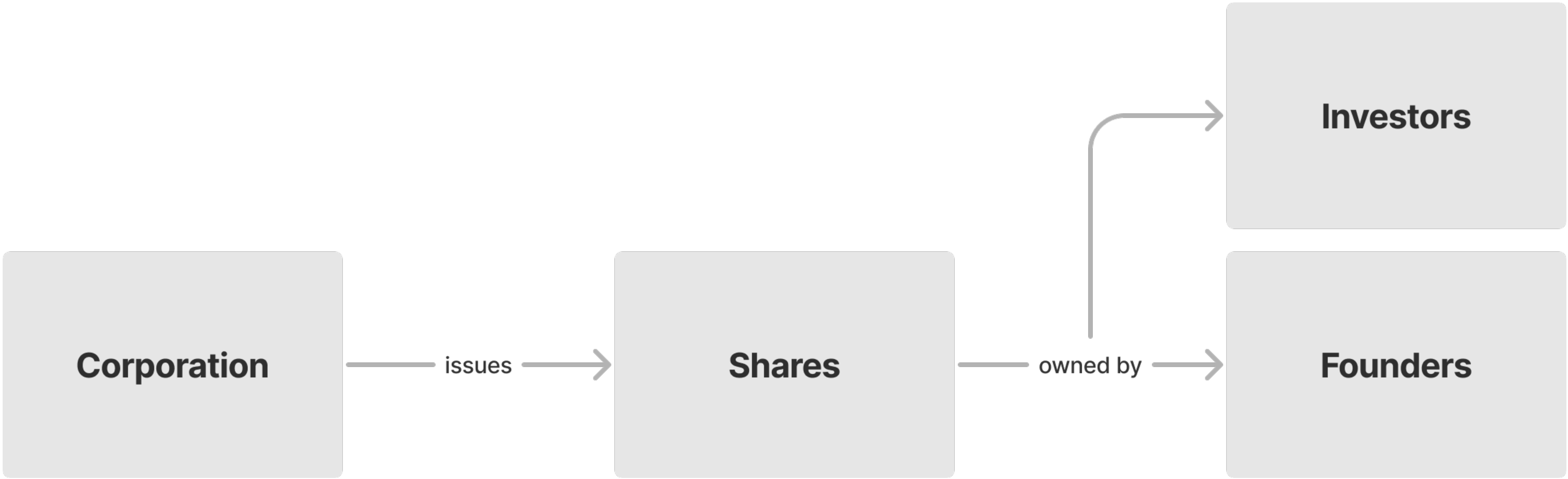
When founders start a company, the company issues shares of stock.



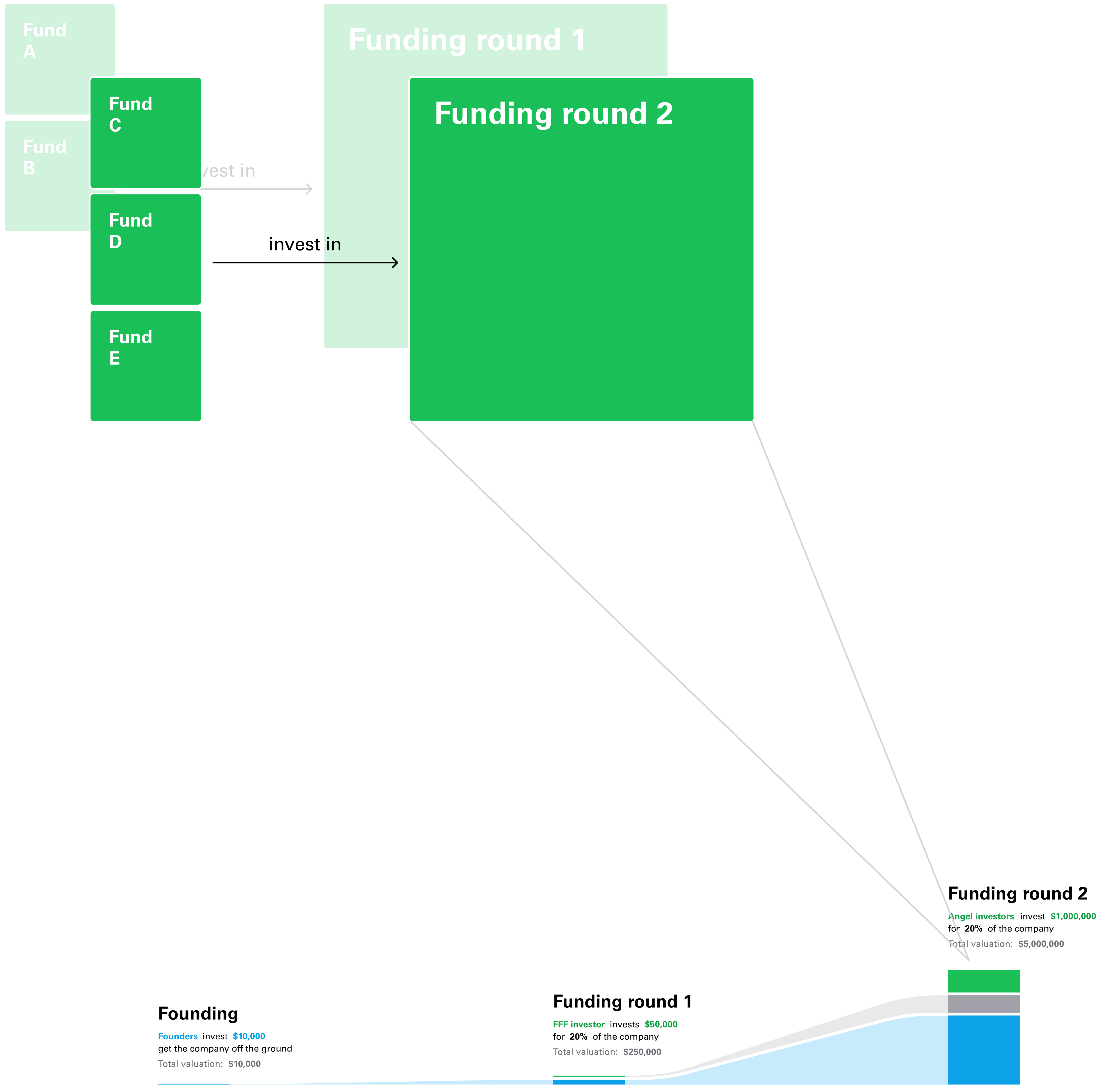
In order to raise capital for operating and growth, owners may sell some of the company.

Typically, attracting investors requires:

- a team
- a product idea
- a pitch deck
- a product demo
- a plan for growth

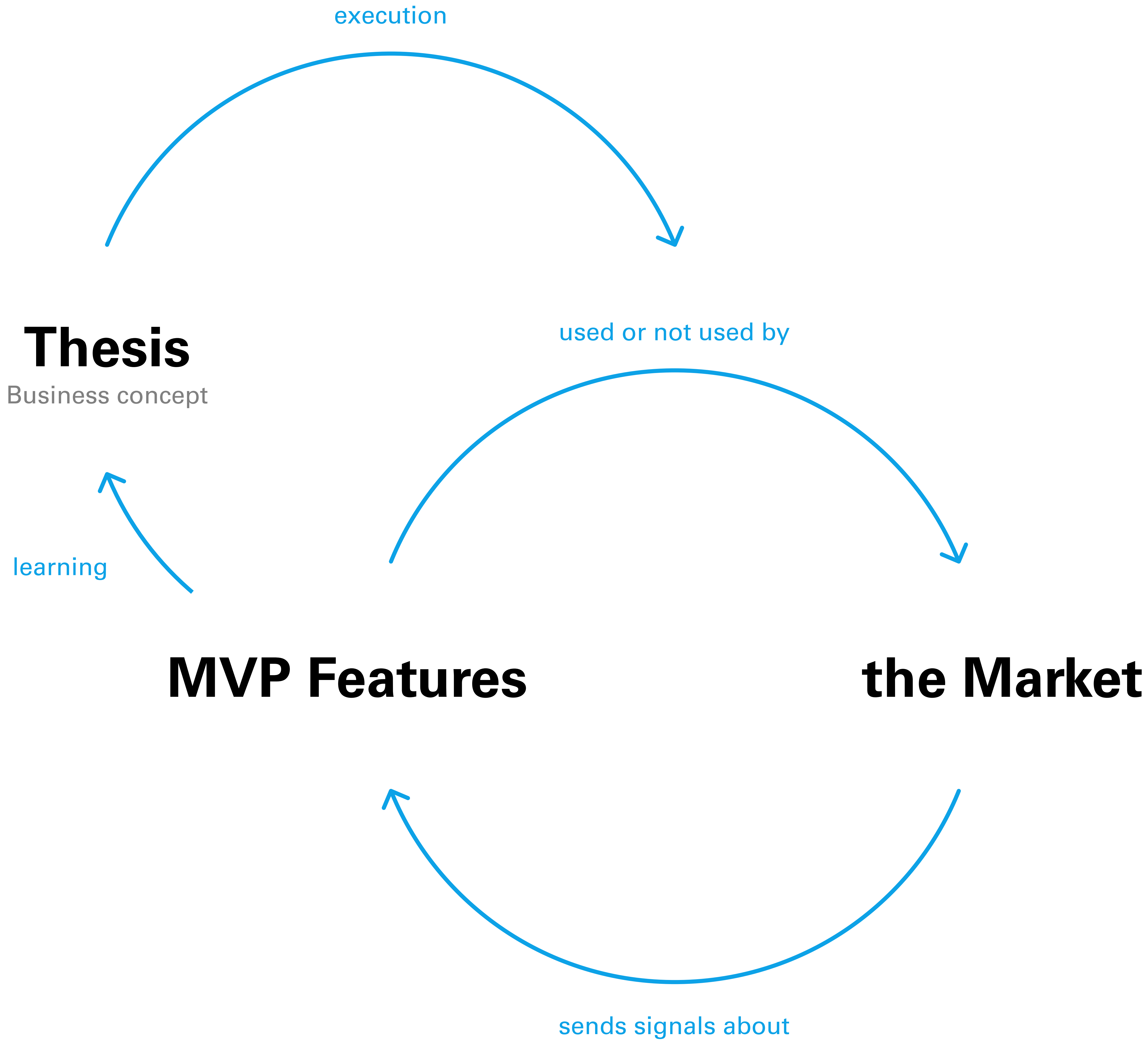


Startups seek funding in a series of phases called 'funding rounds'. In early funding rounds, companies sell shares to groups of VC funds.

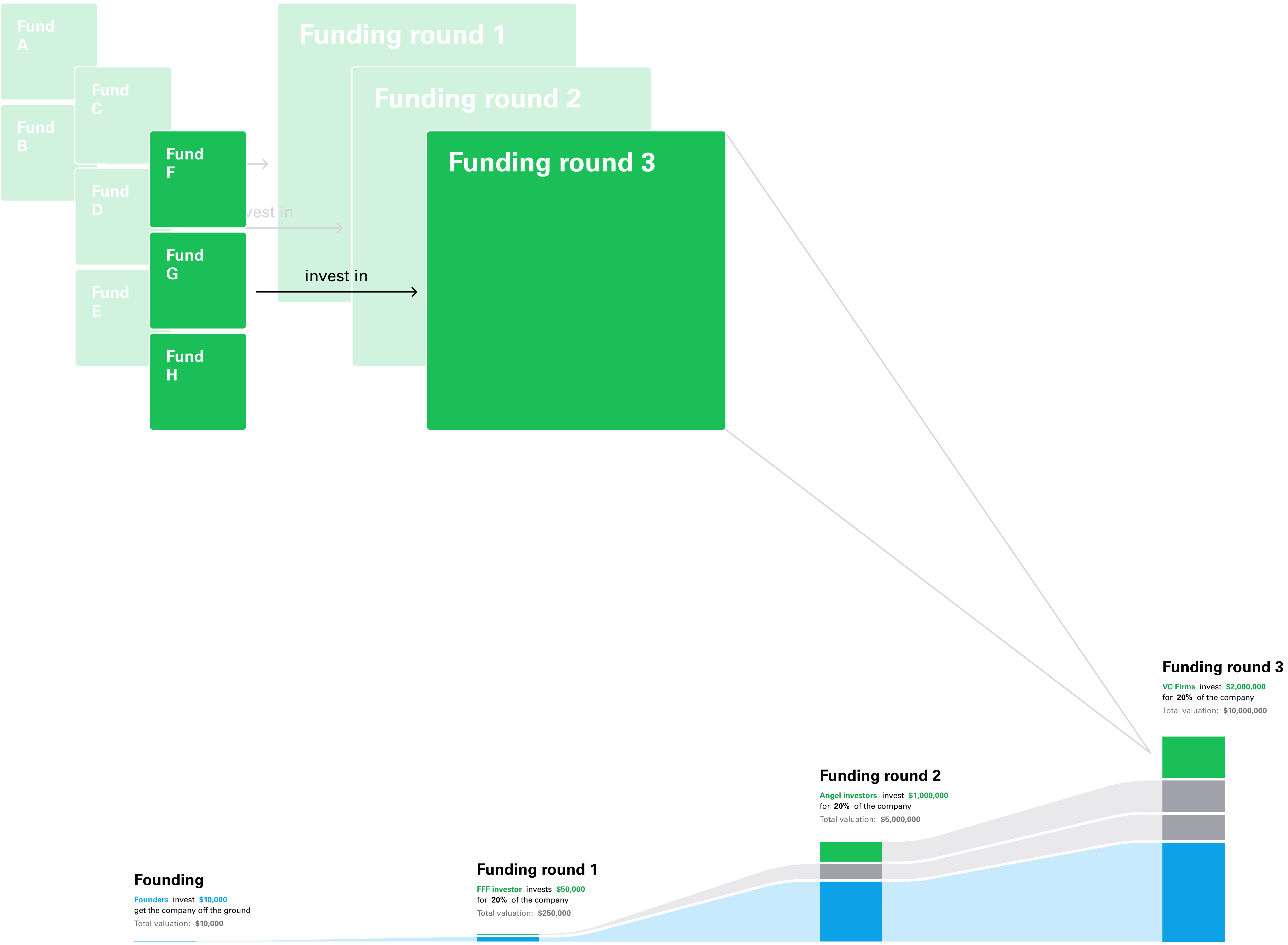


The Startup uses the investment to hire people and build and launch an MVP.

The goal is to the most basic yet useful product,
the so-called minimum viable product,
in order to ship as soon as possible,
in order to get feedback from the market quickly,
so as to understand what matters to real users,
so as to improve and expand those features.

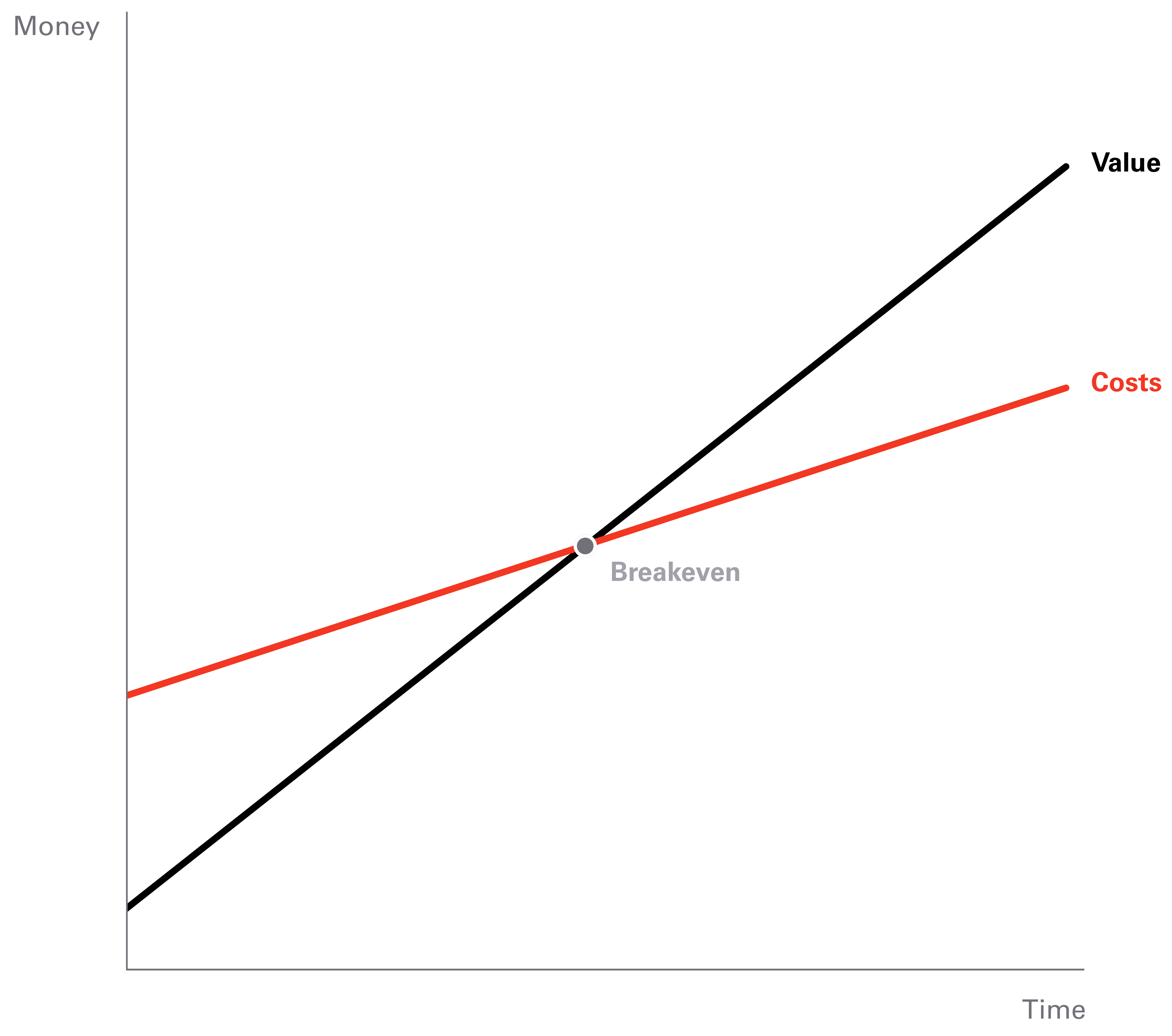


If usage grows, the Startup might raise more money, selling shares to a new group of VC funds in another round.

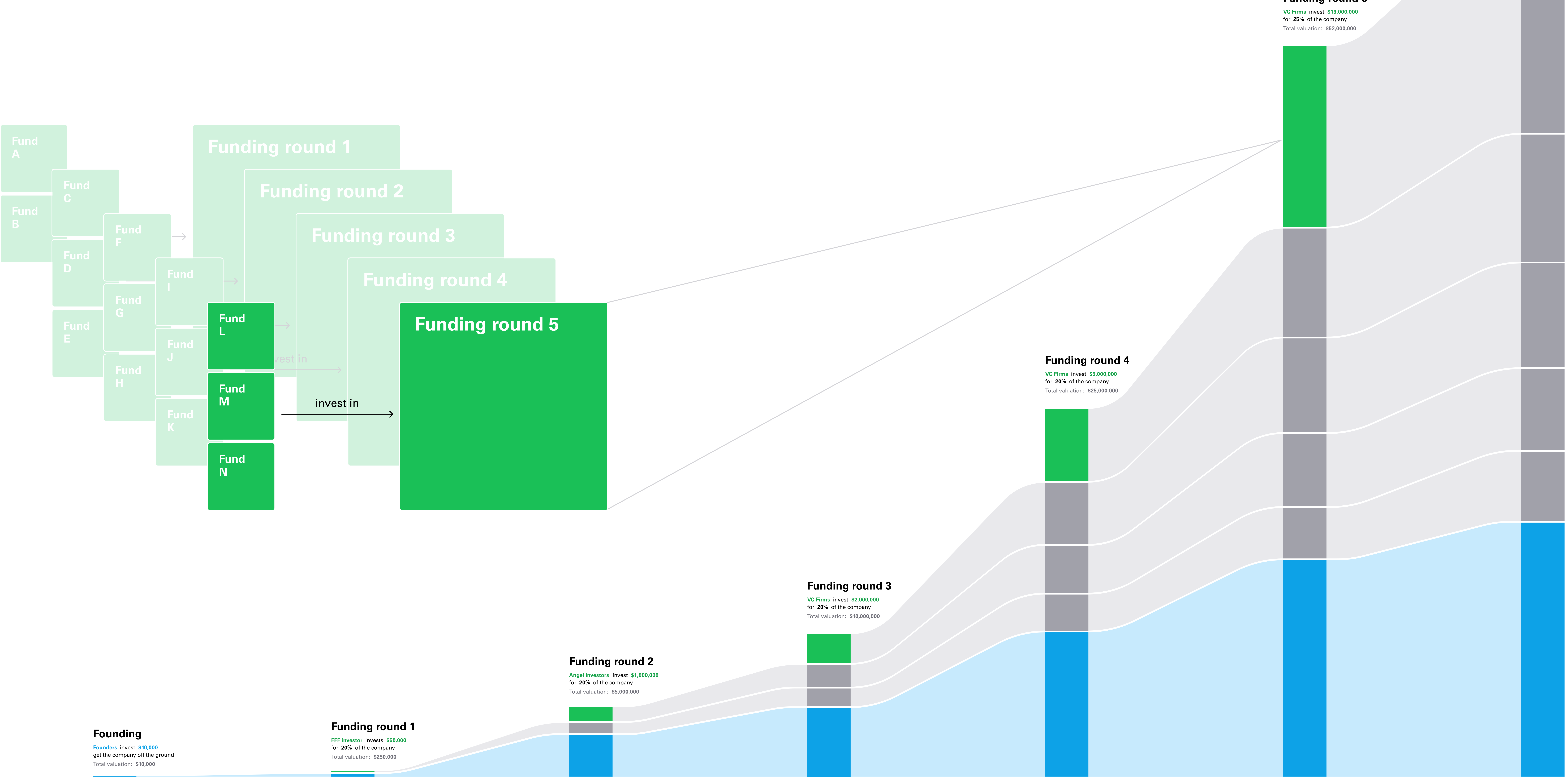


The Startup uses the proceeds of the investment to hire more people, improve the product, and grow value.

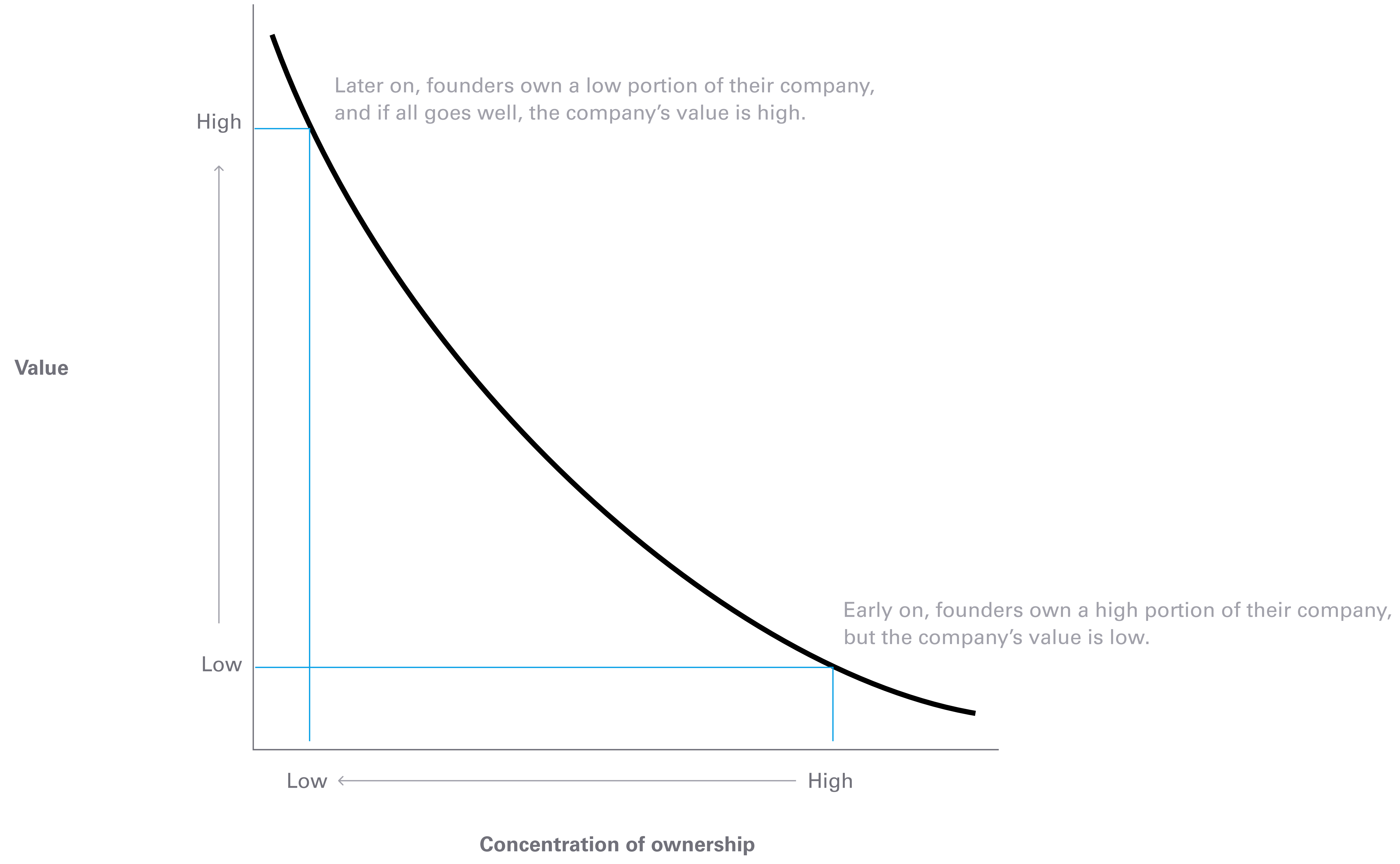
The first goal is exponential growth in the number of users.
The second goal is to break even, followed by increasing returns.



If growth continues, the Startup might raise still more money; or issue more shares for an IPO (Initial Public Offering).



Founders trade ownership for capital (funding)
in order to grow the company (customers & revenue)
in order to grow its value (stock price).
Ultimately, all of the investors profit
including the founders.

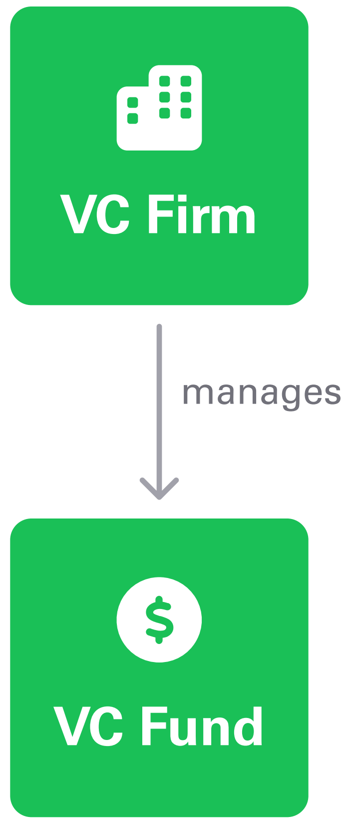


PART THREE

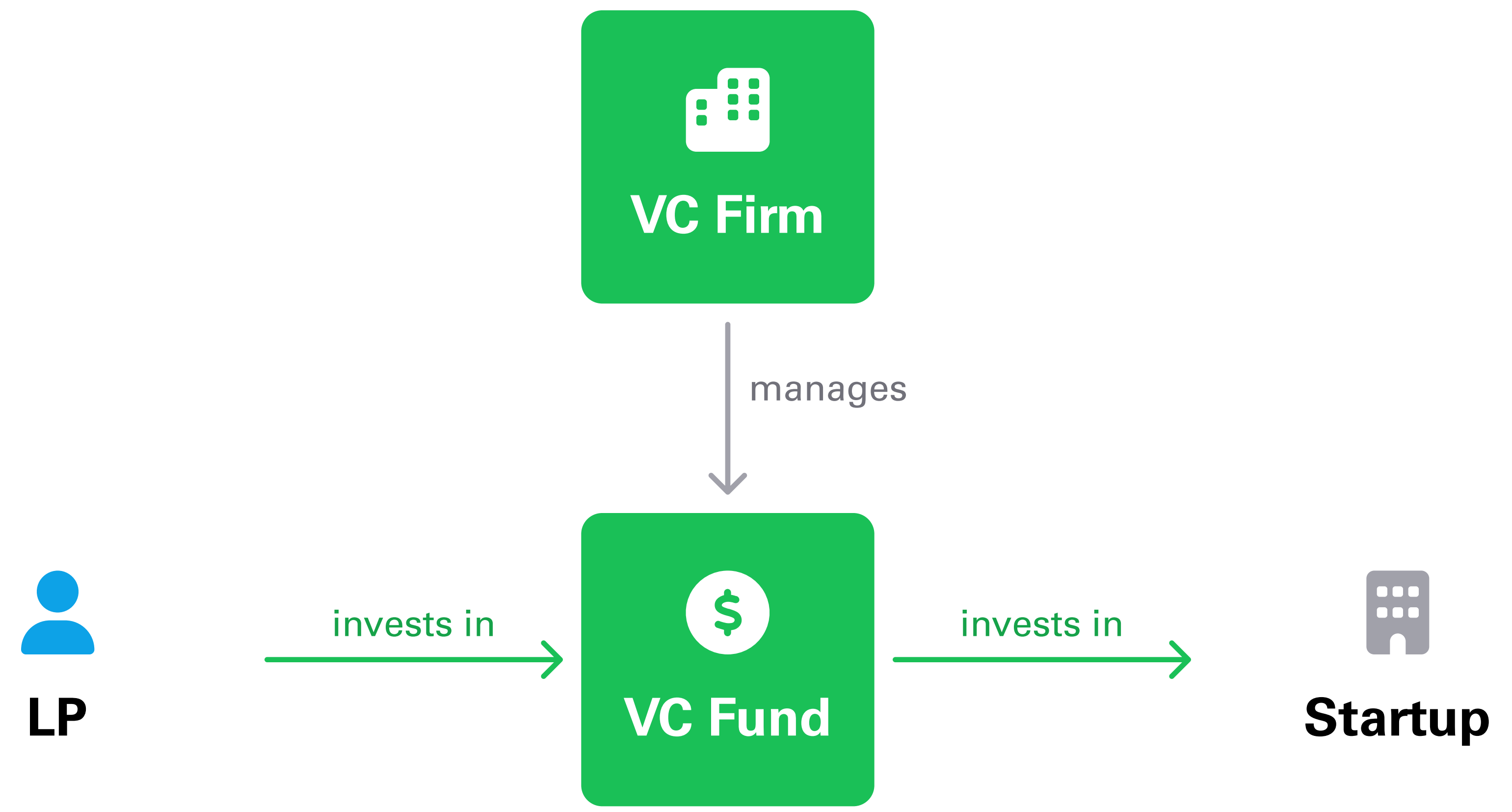
The VC Firm's perspective

The goal is to invest in startups
which generate better-than-market returns.

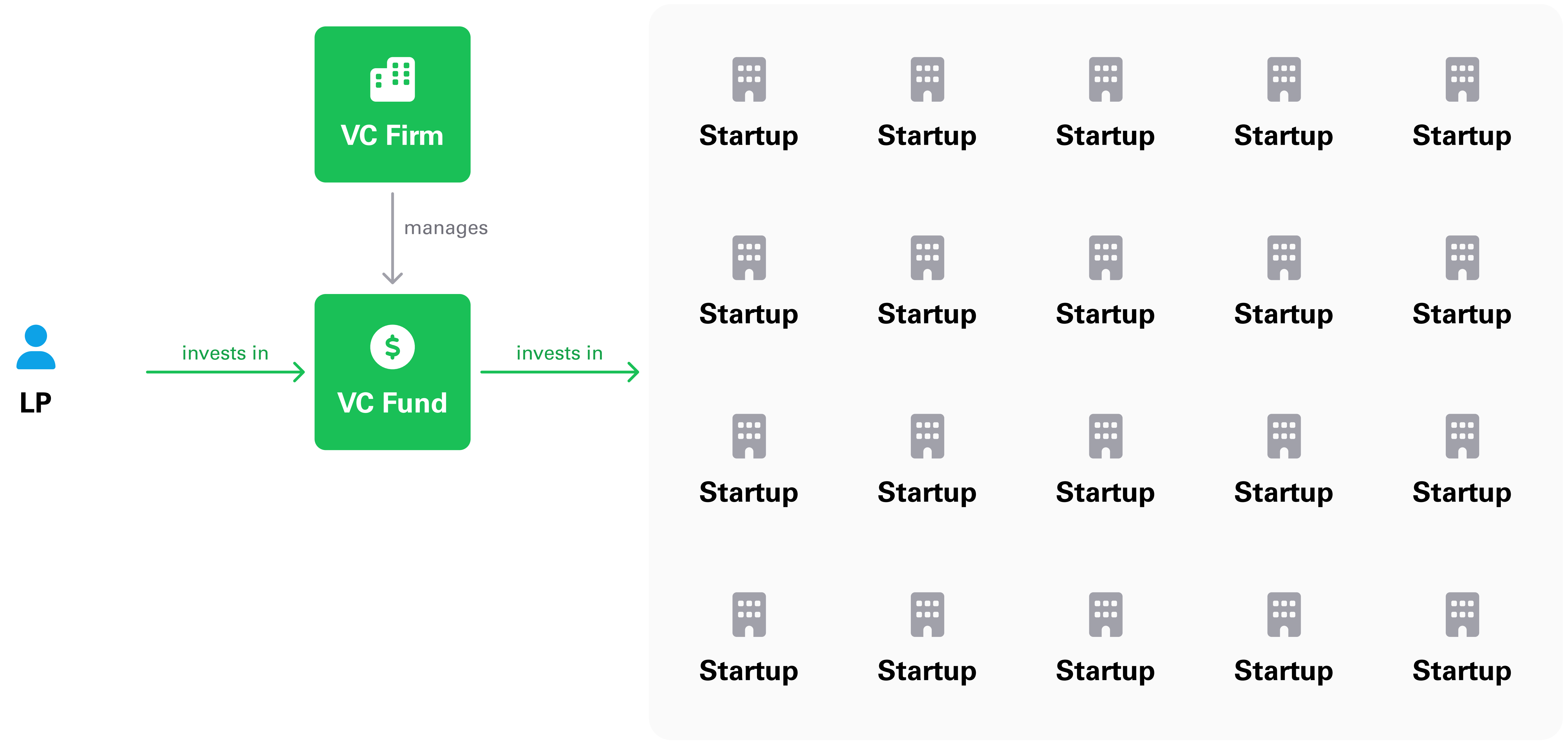
In order to provide startups with access to capital, VC firms create VC funds.



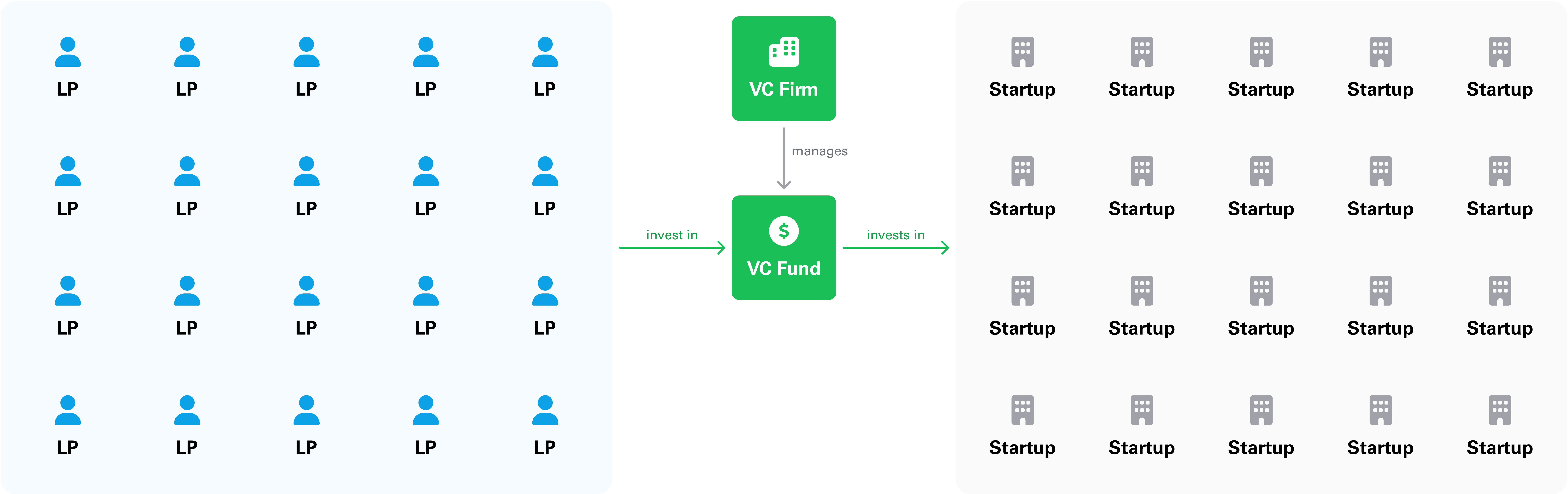
VC funds are ‘limited partnerships’, in which investors become limited partners (LPs) to gain access to startups — a high-risk asset class.



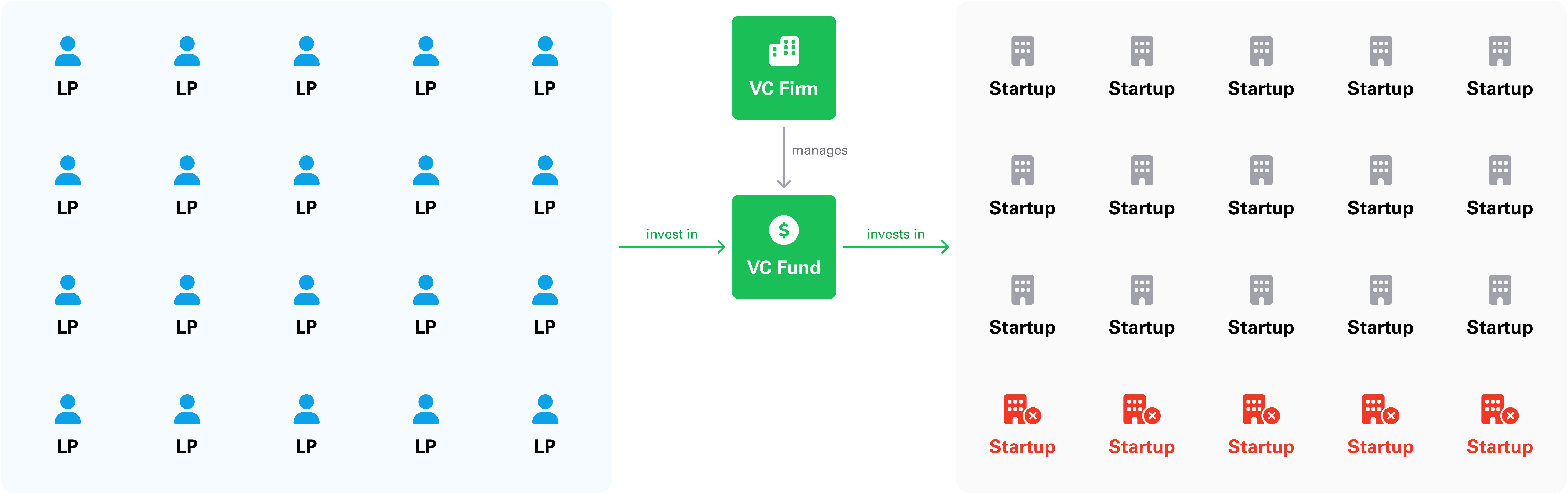
In order to reduce risk and maximize potential returns, VC Firms bundle the fund's investments in many startups.



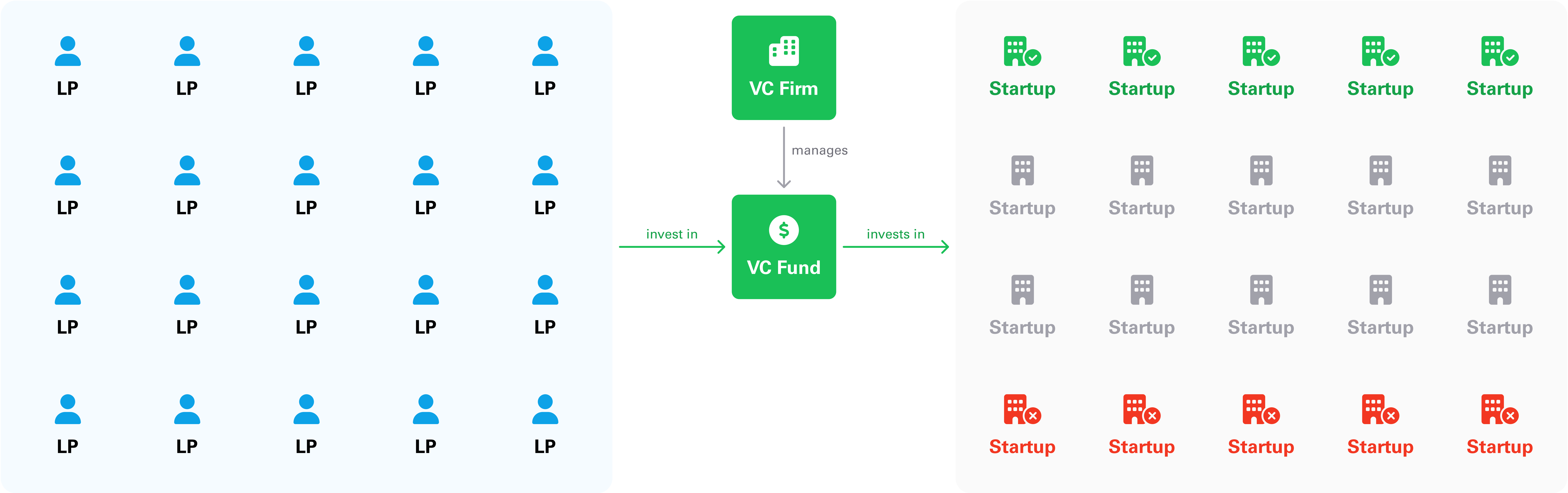
In order to have enough capital to invest in many startups, VC funds bundle investments from many LPs.



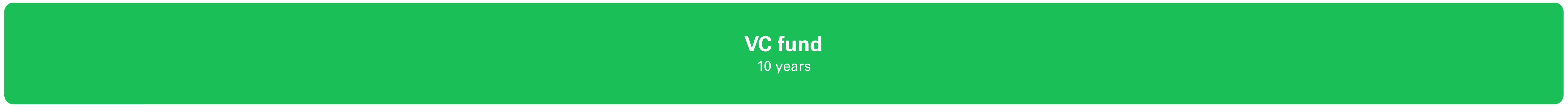
Each startup should have the potential to return the entire amount invested in the fund (the fund size). However, about a quarter of the startups are likely to fail.



A third to half may breakeven,
and a third to perhaps 10% will be responsible for all of the returns.

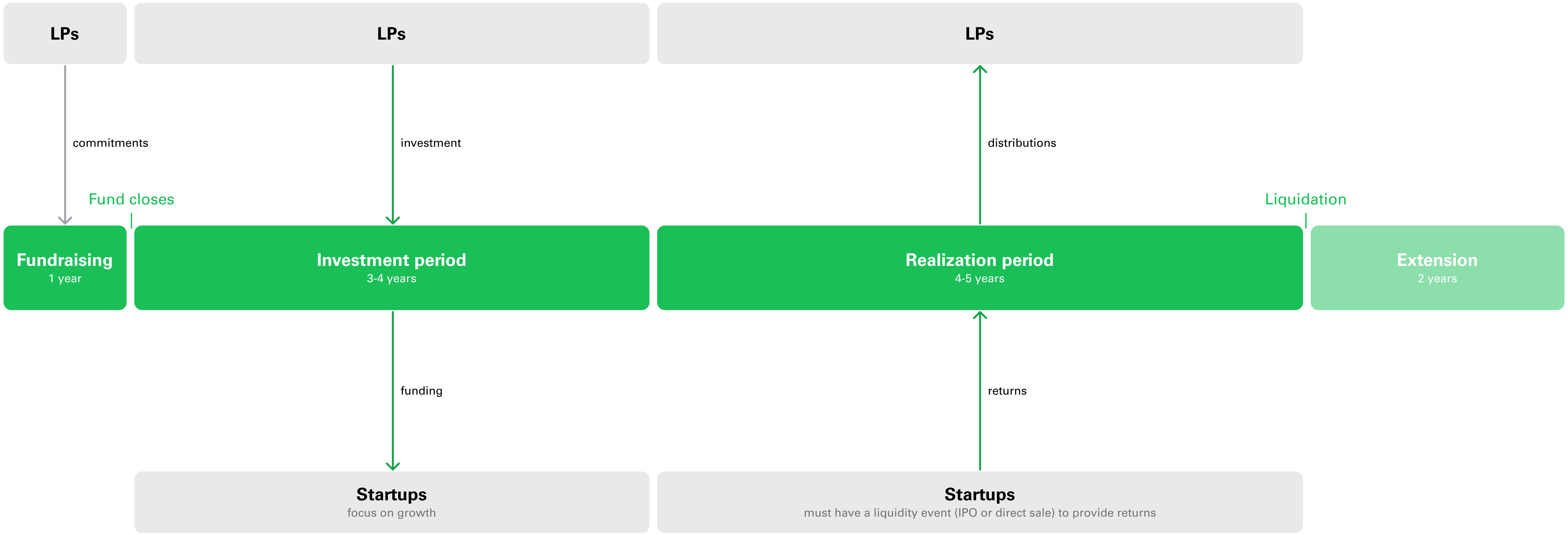


VC Funds have a limited lifespan;
typically, they return money to investors after about 10 years.
For this reason, funds are sometimes referred to as “vintages”.

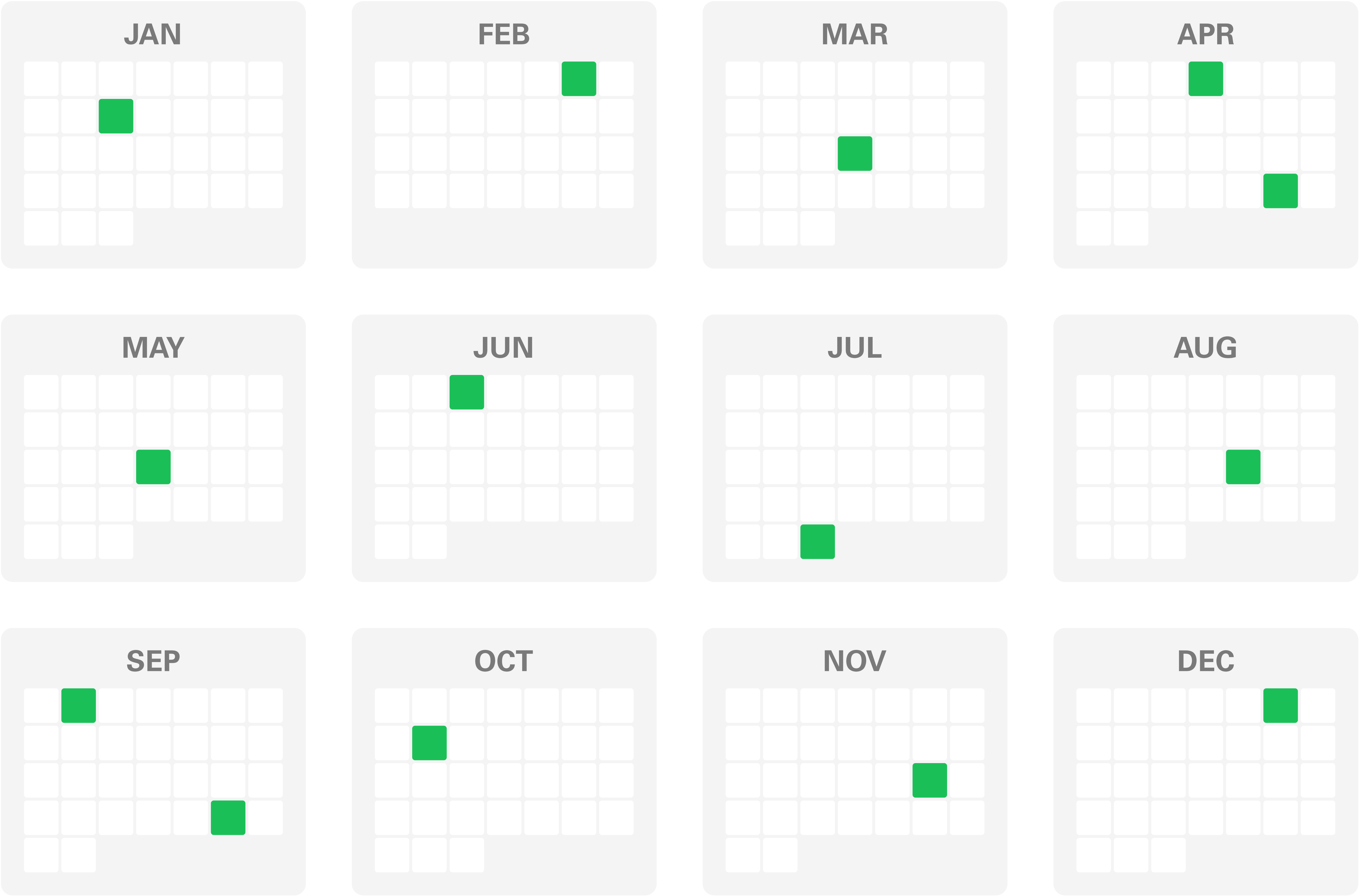


Each VC Fund has a life cycle with life stages.

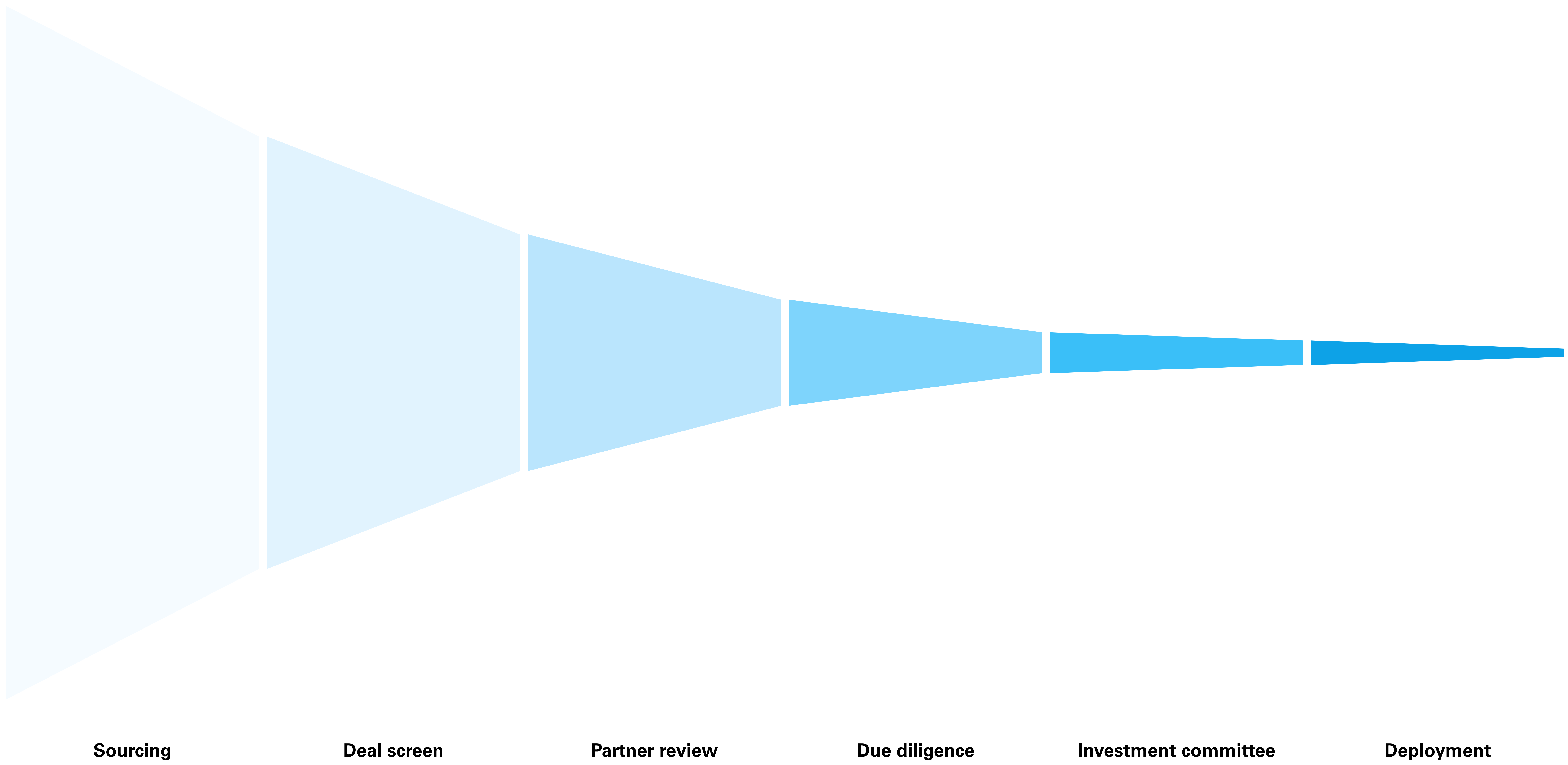
- **Fundraising period:** LPs (investors) make commitments to the fund.
- **Investment period:** LPs make investments which are deployed to startups.
- **Realization period:** Returns are distributed to investors.
- **Extension:** some funds may be extended depending on market conditions.



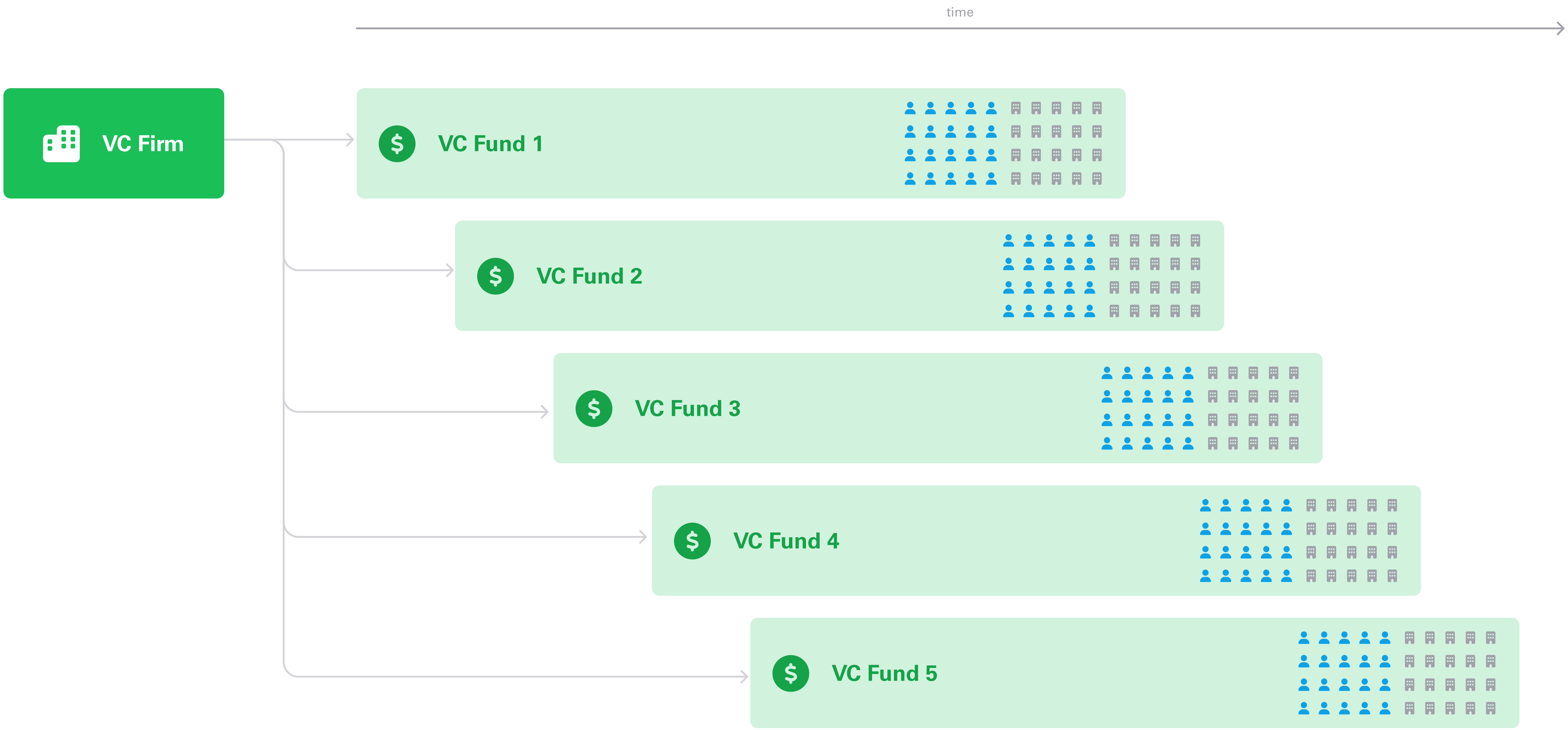
Deal flow becomes important — finding startups with the potential to return the fund size.
Even with a small fund, that might mean funding one startup every month.



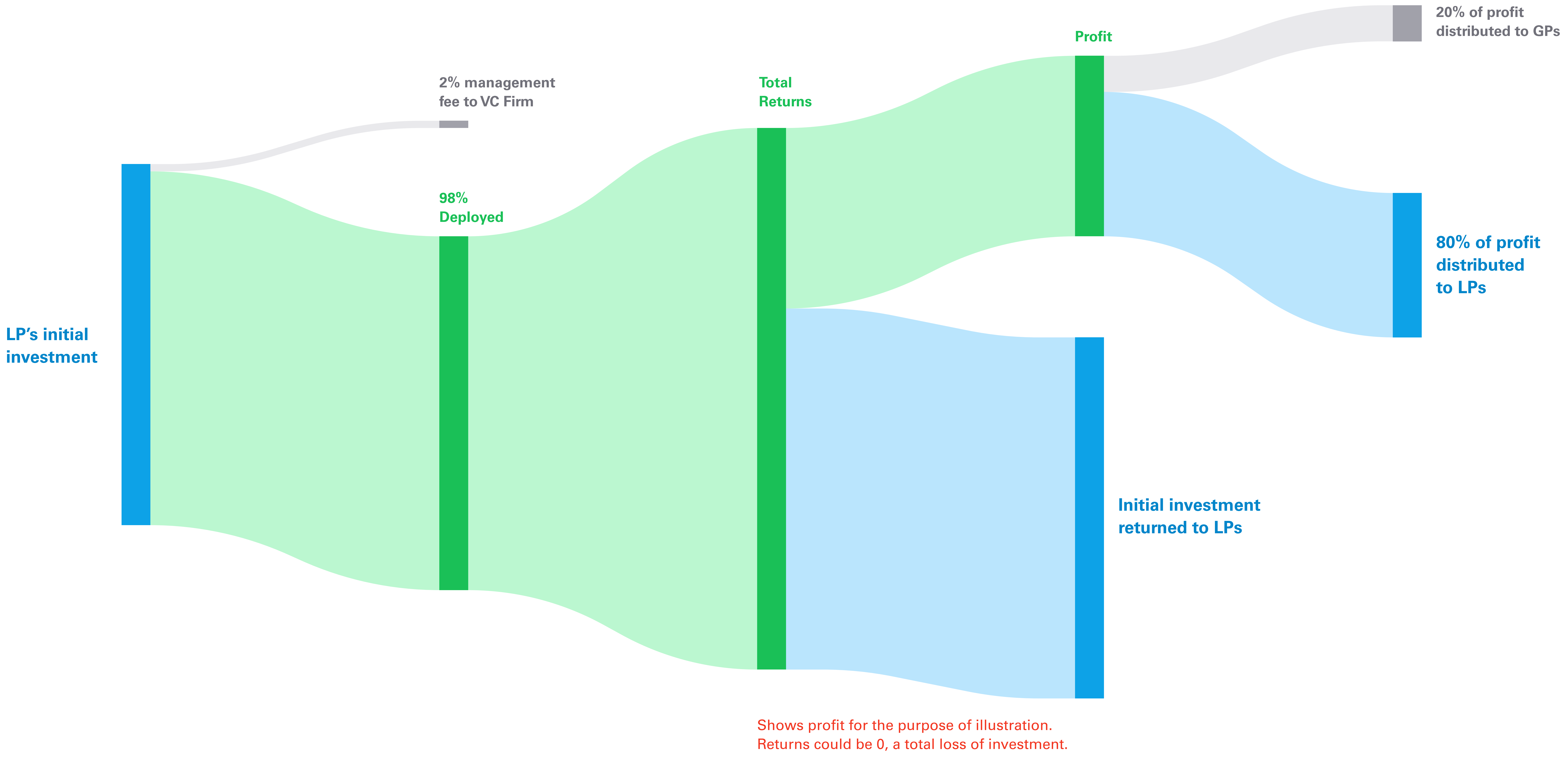
A key part of selecting startups to invest in is fitting them into an ‘investment thesis’ — in other words, defining selection criteria for the fund.



This process repeats as a VC firm creates additional funds.



Typically, 2% of each LP's investment is taken annually as management fees.
After the fund returns all of the investors' capital, they have profit to distribute to the investors, but the General Partners usually keep 20% of this profit.



PART FOUR

The LP's perspective

The goal is to diversify their portfolio
by getting access to a high-risk asset class
that can generate outsize returns.

Limited Partners (LPs) are investors.

High net-worth individuals

Family offices
(managing assets for several relatives)

Pension funds
(managing retirement for large groups)

Foundations
(managing an endowment)

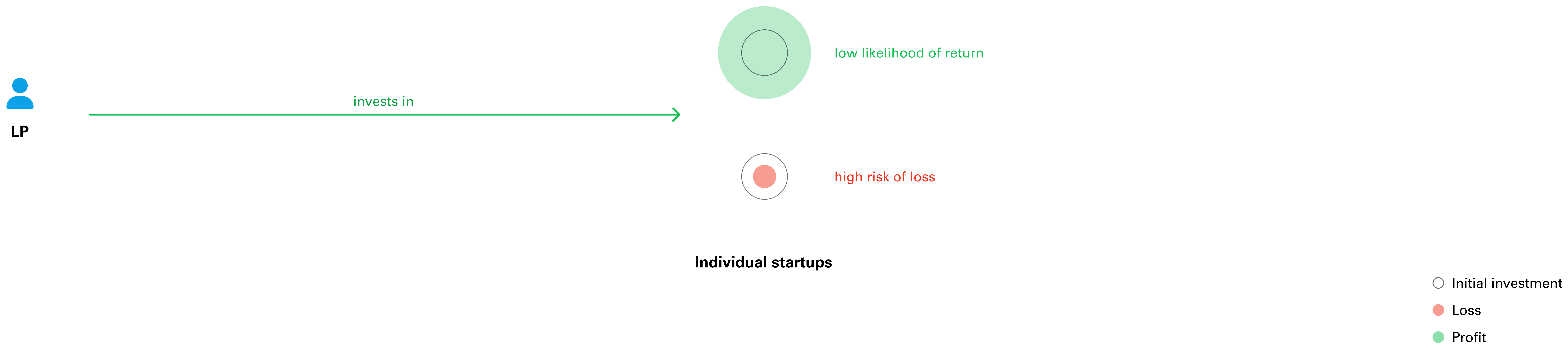
Sovereign wealth funds

University endowments

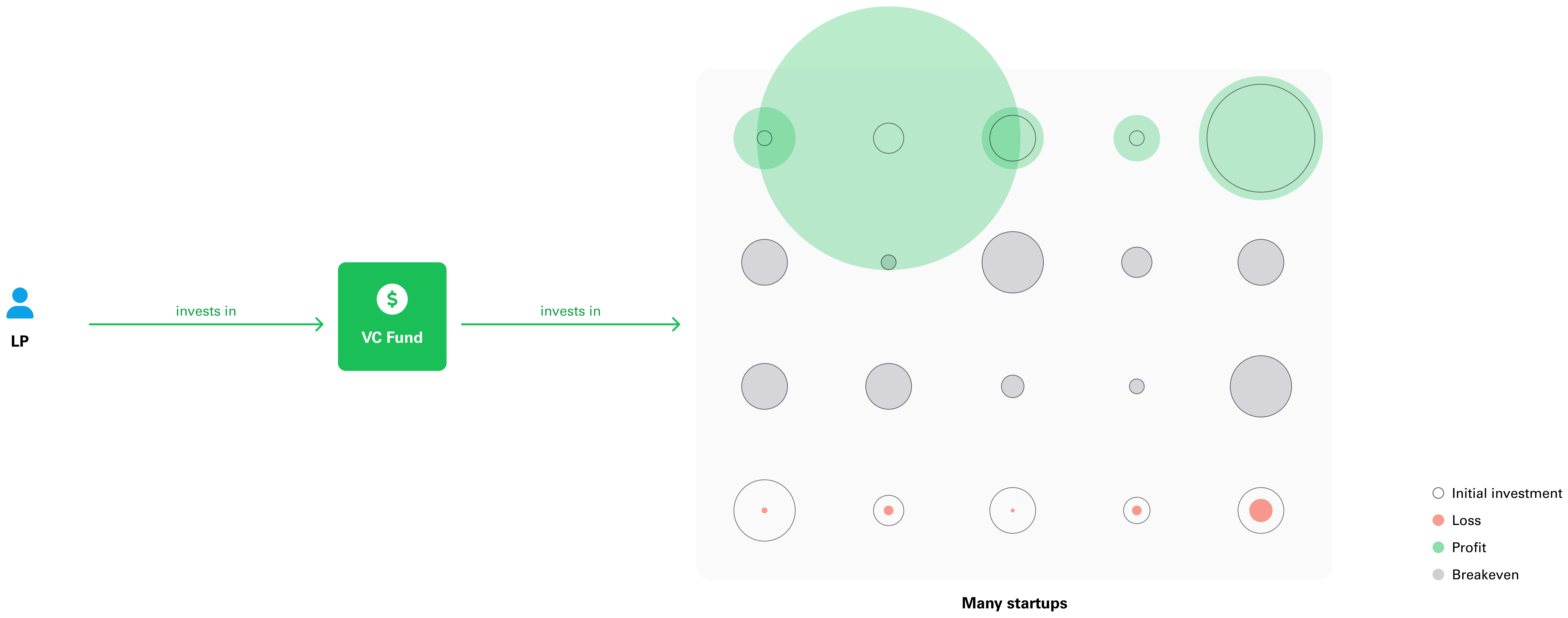
Insurance companies

Other companies

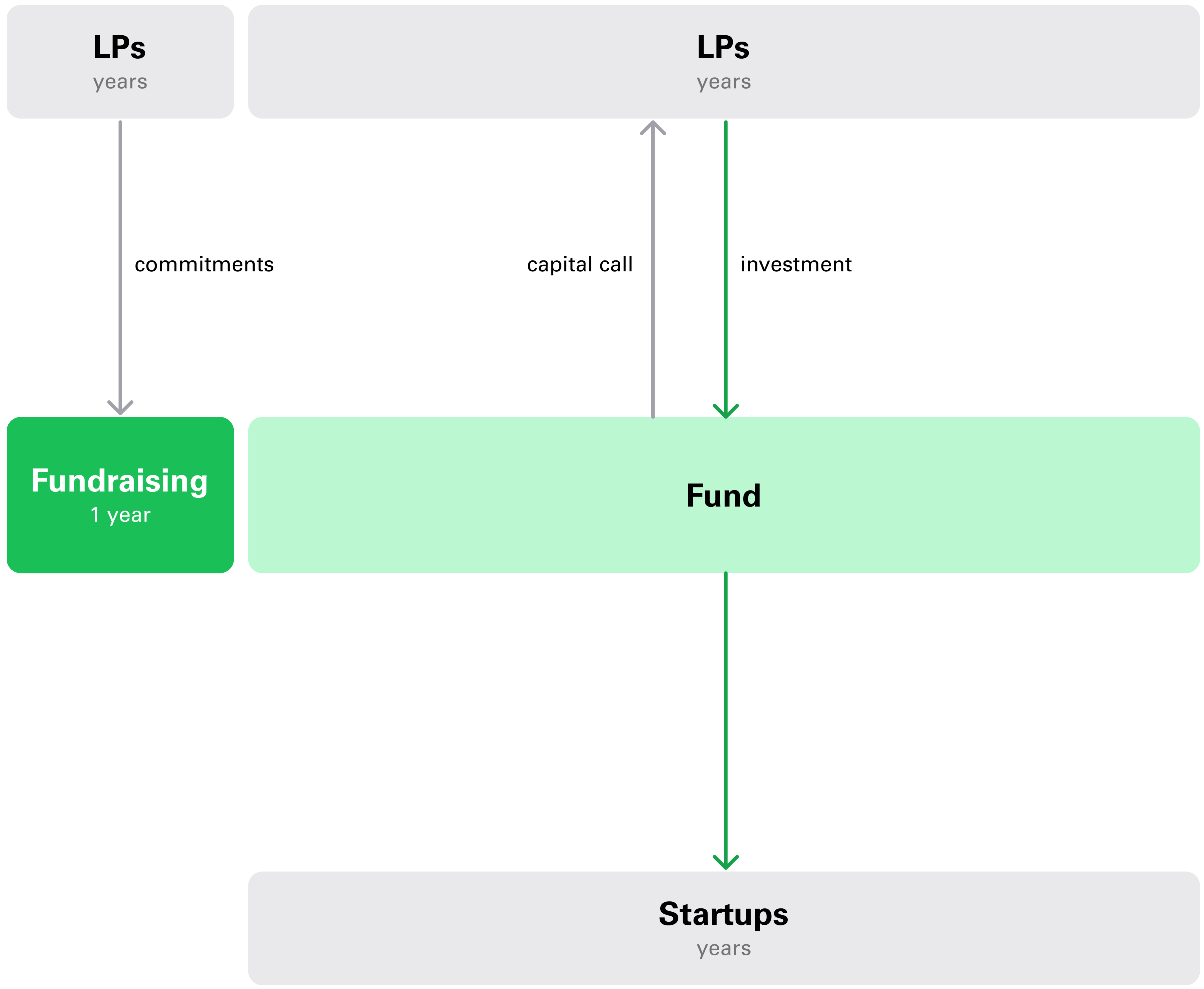
LPs could invest directly in individual, early-stage startups.
However, finding opportunities, evaluating them, and managing them would be time consuming —
and investing in a single startup would be extremely risky,
with a low likelihood of return.



By investing in a VC fund, which has bundled 20 or even 100 startups, LPs spread their risks and increase the likelihood of participating in a successful company.

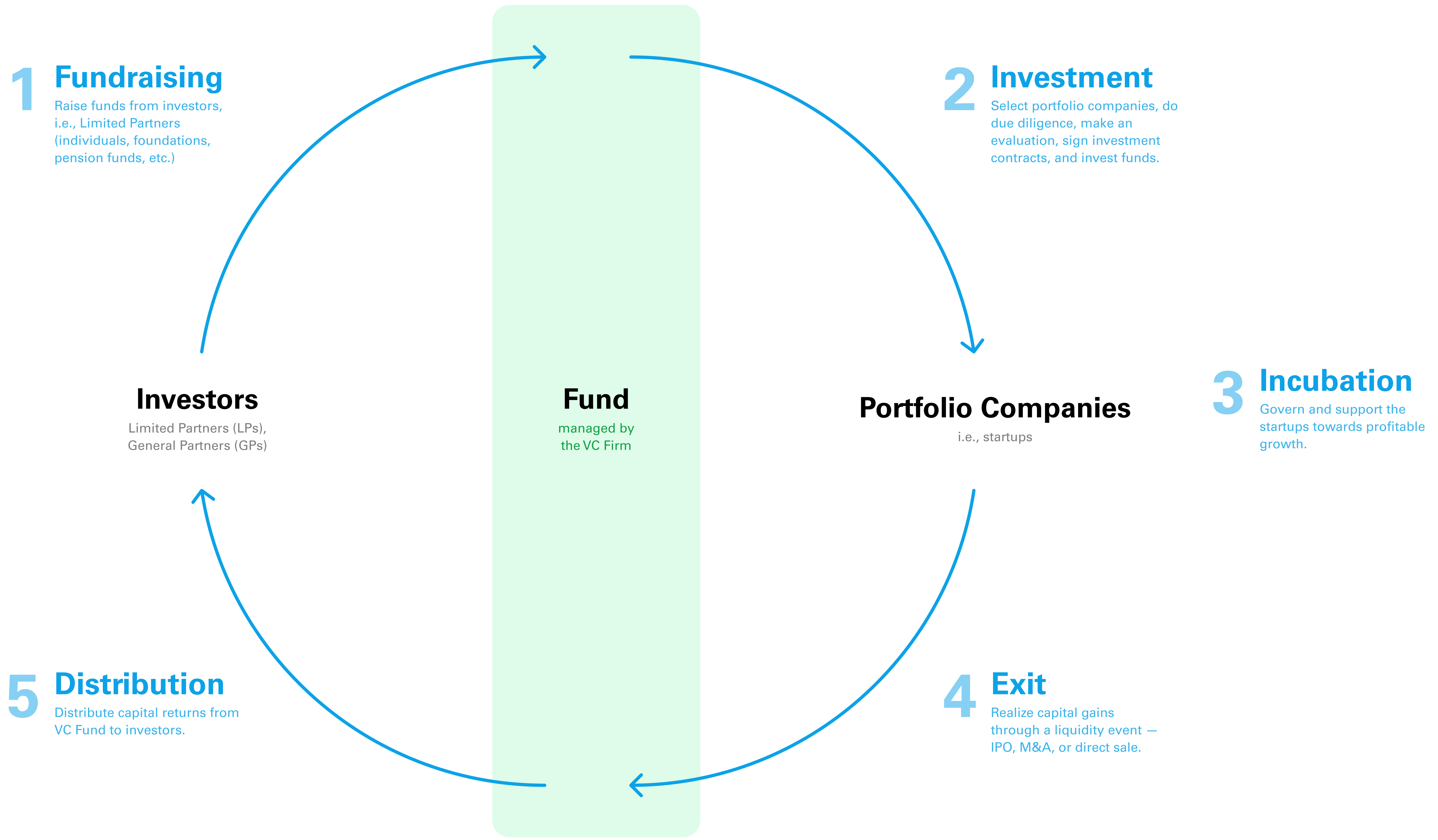


When LPs "subscribe" to a fund,
they commit to providing money when a VC fund invests in a startup.
Investors agree to fund when called upon (i.e., a "capital call").
Thus, the LPs money never sits "in" the fund, except very briefly as it passes through.

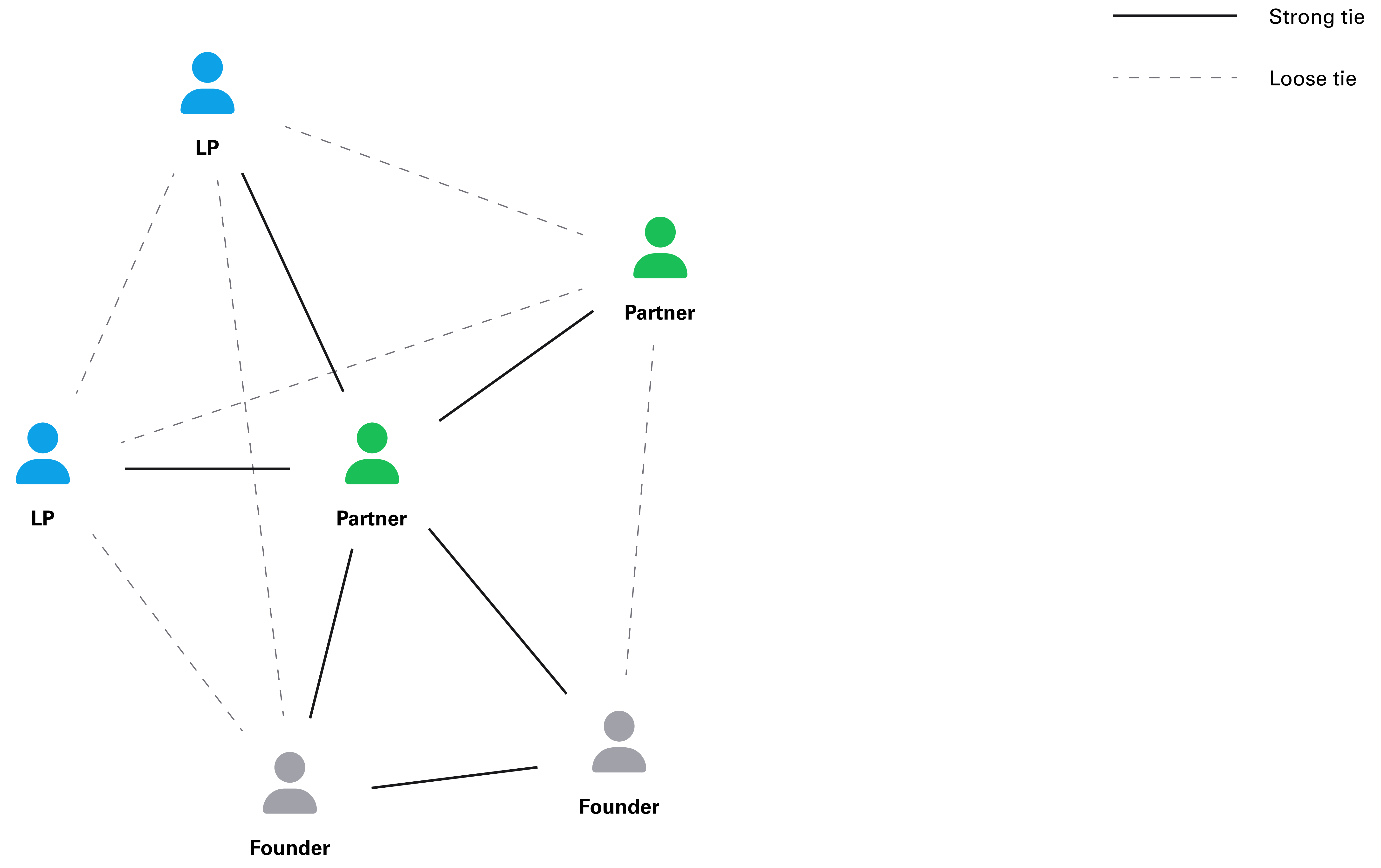


VC investment becomes a feedback loop of capital.

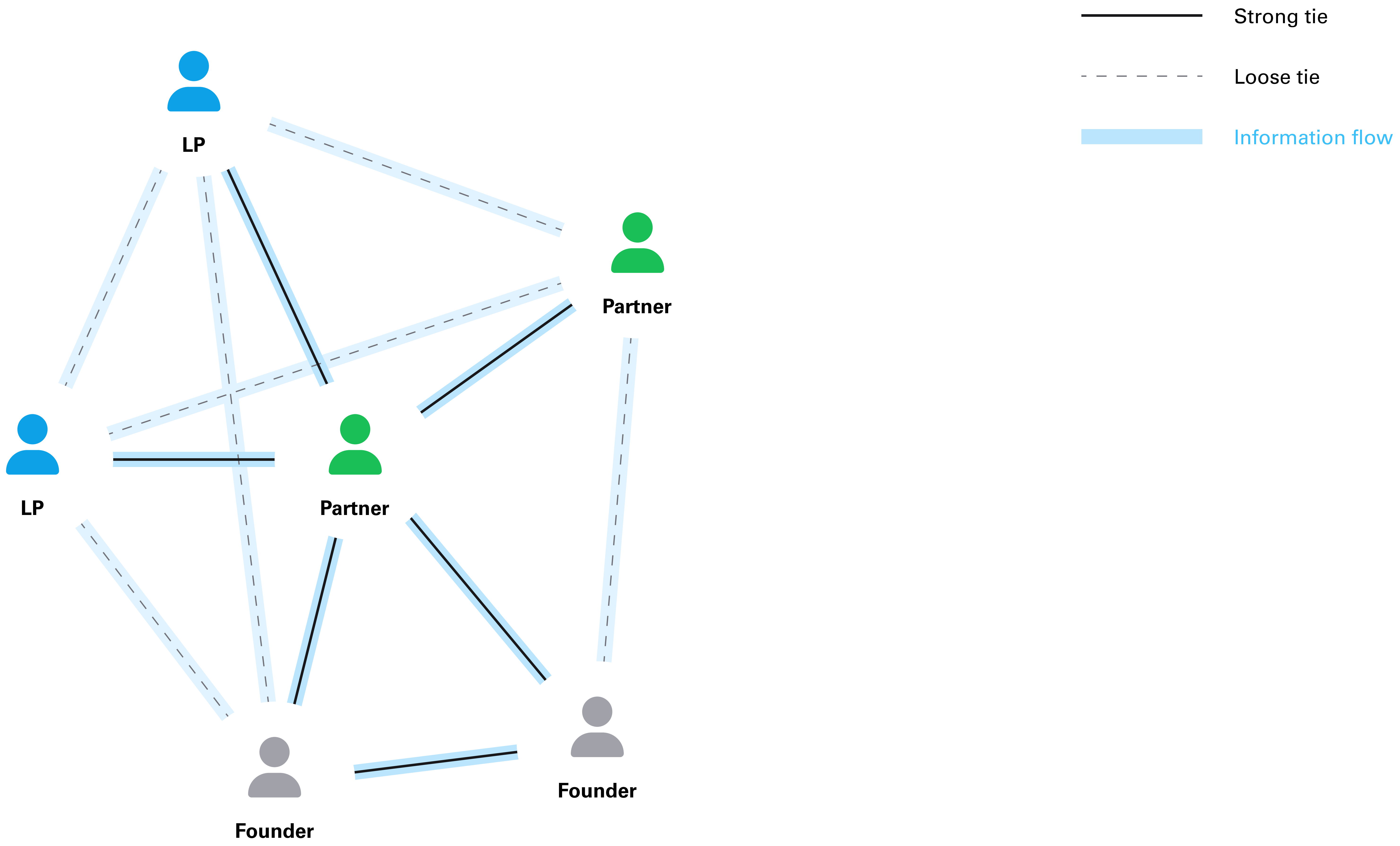
Distributions from an earlier fund may be reinvested in later funds.



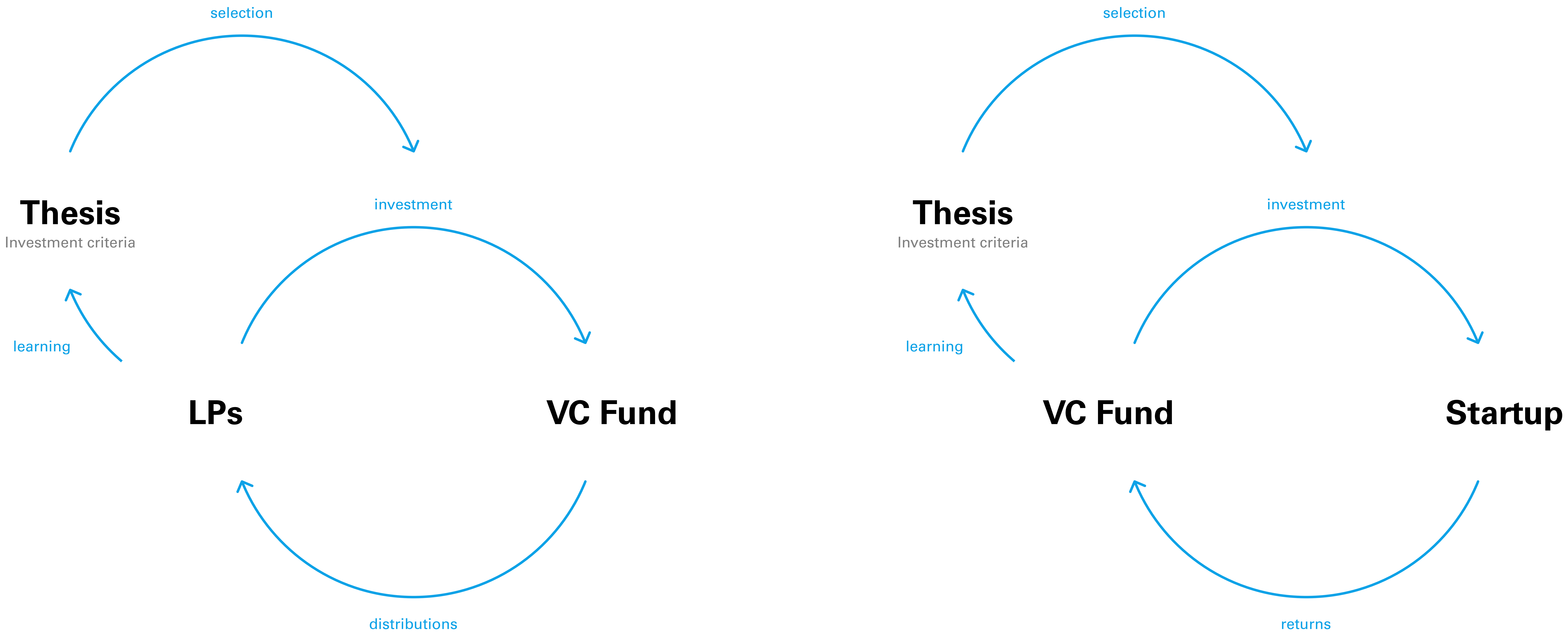
Investing in a VC fund may also pay social dividends; that is, LPs can network with other LPs, GPs, and founders.
Startups and their founders also benefit from the “loose ties” that they make in the VC network.



The network shares information or signals about what’s happening, who's going where, and histories (e.g., who’s delivered what).

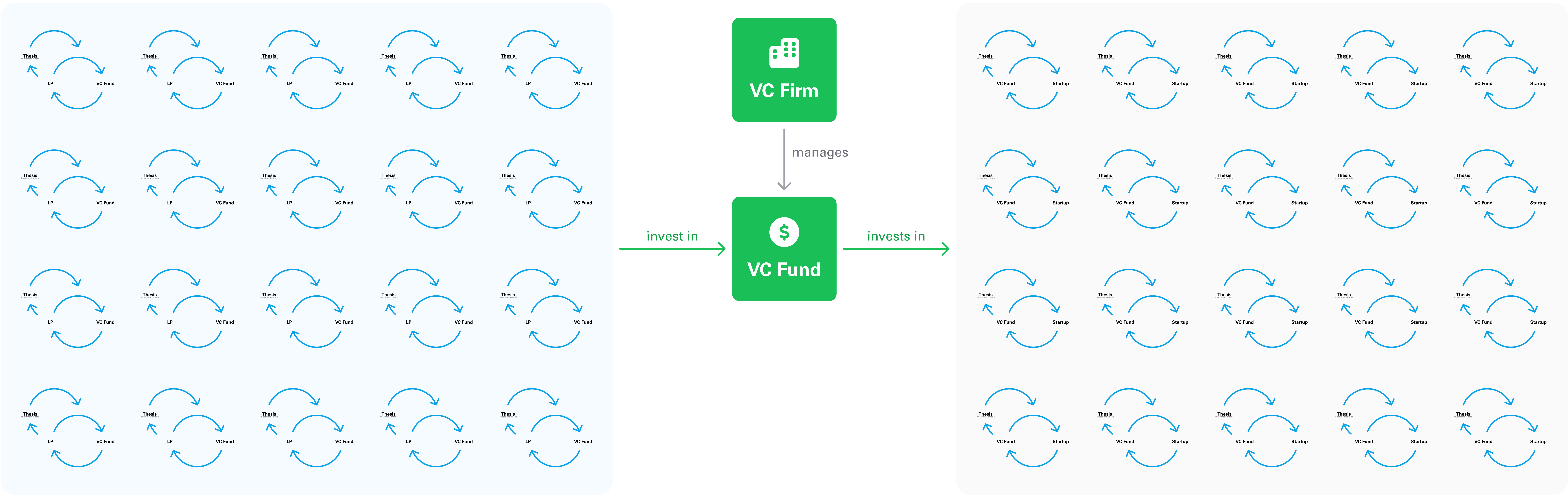


LPs investing in funds, and funds investing in startups is an important form of what economist Friedrich Hayek calls "price signaling" — exchanging fundamental information on the market.



Each investment is an experiment to learn more about what the market wants.

In this way, the market moves resources to people and ideas that seem most likely to deliver the most returns.



Appendix

Appendix

Articles of Incorporation + operational documents

Articles of incorporation are a set of formal documents filed with a government body to legally document the creation of a corporation. They generally include the company's name, type of corporate structure, the address and name of the agent for service of process, and the number and type of authorized shares. Other operational documents may include bylaws (which govern the company's operations), shareholder agreements, stock purchase agreements, and operating agreements for LLCs, which set out the roles of the members and the distribution of earnings.

Company governance

The mechanisms, processes, and relations by which corporations are controlled and directed. It encompasses the regulatory framework, including the board of directors, management policies, and rules and procedures for making decisions on corporate affairs. Company structure, on the other hand, refers to the organization of various departments or business units within a company. It includes the hierarchical setup and the roles and responsibilities assigned to employees within the company.

Funding rounds

Funding rounds are periods during which startups seek to raise capital from investors. These rounds are typically categorized in order, from seed capital (the initial funding used to prove a new idea), followed by Series A, B, C, etc., each progressively aimed at scaling the company, with the valuation typically increasing with each round.

Impact investors

Impact investors are individuals or companies that are committed to investing in ways that generate measurable social and environmental impact alongside a financial return. They focus on industries and companies that can provide solutions to global challenges such as climate change, health, education, and social justice, among others. Impact investing can occur in both public and private markets. Bill and Melinda Gates are examples of impact investors.

Market cap

Market capitalization (market cap) refers to the total value of a company's outstanding shares of stock. It is calculated by multiplying the current share price by the total number of outstanding shares. Market cap provides a quick estimate of a company's value and is used to categorize companies into different sizes. While revenue is the income generated from sales, and profit is the income remaining after all expenses have been deducted, market cap is a reflection of what investors are willing to pay for the company's stock.

Preferred vs common shares

Preferred shares are a class of ownership in a corporation that has a higher claim on its assets and earnings than common shares. Preferred stock typically comes with a fixed dividend, while common shareholders may receive dividends that vary in amount and may not be issued at all. Preferred shareholders typically do not have voting rights, unlike common shareholders who usually do.

TAM

Total Addressable Market (TAM) refers to the total market demand for a product or service. It is the maximum amount of revenue a business could possibly generate by selling their product or service in a particular market. Companies often estimate TAM when entering a market to understand the growth potential and to make strategic decisions about product development, marketing, and sales efforts.

VCs do not invest in research projects, their primary interest is commercialization and scaling.

Market Cap

	Market cap		Share price		Number of outstanding shares
			as of close of market, April 3, 2024		
AAPL	**$2.62 trillion**	=	$169.58	x	15.51 billion shares
MSFT	**$3.11 trillion**	=	$425.52	x	7.43 billion shares
META	**$1.30 trillion**	=	$510.92	x	2.55 billion shares

Special thanks to
Gavin Miller