

## WHAT IS VENTURE CAPITAL?

Venture capital has enabled the United States to support its entrepreneurial talent and appetite by turning ideas and basic science into products and services that are the envy of the world. Venture capital funds build companies from the simplest form – perhaps just the entrepreneur and an idea expressed as a business plan – to freestanding, mature organizations.

### Risk Capital for Business

Venture capital firms are professional, institutional managers of risk capital that enable and support the most innovative and promising companies. This money funds new ideas that could not be financed with traditional bank financing, that threaten established products and services in a corporation, and that typically require five to eight years to reach maturity. Venture capital is quite unique as an institutional investor asset class. When an investment is made in a company, it is an equity investment in a company whose stock is essentially illiquid and worthless until a company matures five to eight years down the road. Follow-on investment provides additional funding as the company grows. These “rounds,” typically occurring every year or two, are also equity investment, with the shares allocated among the investors and management team based on an agreed “valuation.” But, unless a company is acquired or goes public, there is little actual value. Venture capital is a long-term investment.

### More Than Money

The U.S. venture industry provides the capital to create some of the most innovative and successful companies. But venture capital is more than money. Venture capital partners become actively engaged with a company, typically taking a board seat and acting as a strategic advisor to the company. With a startup, daily interaction with the management

### Five Largest Public Companies by Market Capitalization<sup>1</sup>

Rank	Company	VC-backed?	Market Capitalization (\$B)	Employees
1	Apple	Yes	646	93,000
2	Google	Yes	449	54,000
3	Berkshire Hathaway		356	316,000
4	Microsoft	Yes	351	128,000
5	Exxon Mobil		314	75,000

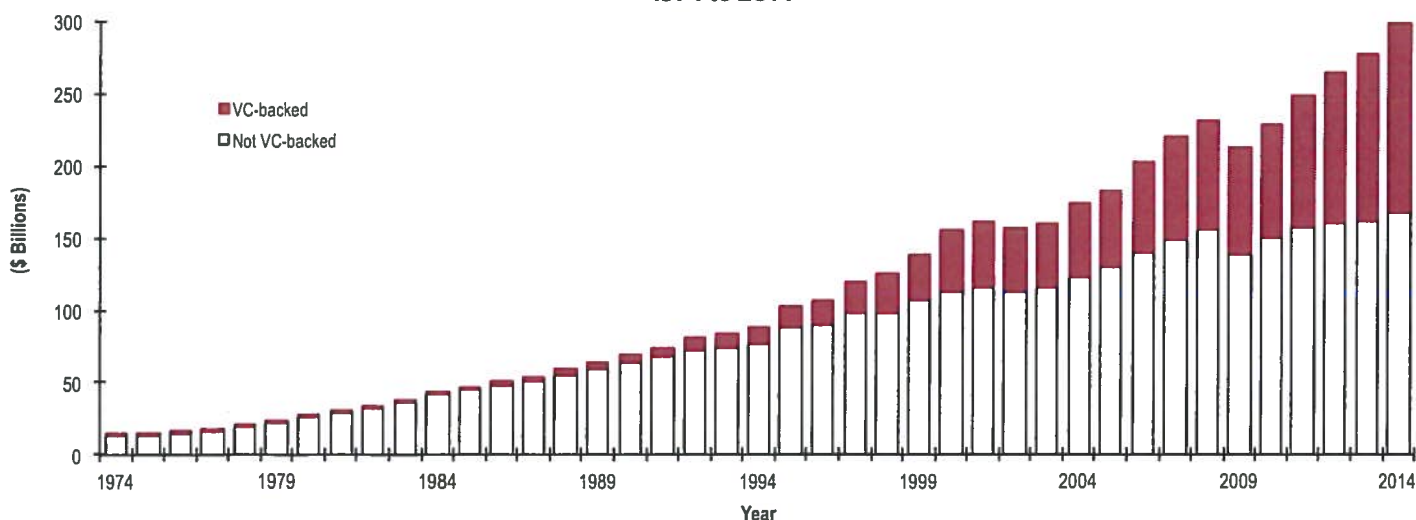
Note: Market capitalization and number of employees are from Thomson One as of August 28, 2015.

team is common. This limits the number of startups in which any one fund can invest. Few entrepreneurs approaching venture capital firms for money are aware that they essentially are asking for 1/6 of a person! Yet that active engagement is critical to the success of the fledgling company. Many one- and two-person companies have received funding, but no one- or two-person company has ever gone public! Along the way, talent must be recruited and the company scaled up. Ask any venture capitalist who has had an ultra-successful investment and he or she will tell you that the company that broke through the gravity evolved from the original business plan concept with the careful input of an experienced hand.

### Deal Flows — Where The Buys Are

For every 100 business plans that come to a venture capital firm for funding, usually only 10 or so get a serious look, and only one ends up being funded. The venture capital firm looks at the management team, the concept, the marketplace, fit to the fund’s objectives, the value-added potential for the firm, and the capital needed to build a suc-

Research & Development Spending by Venture-backed Public Companies<sup>1</sup>  
1974 to 2014



**100 Highest Market Capitalization U.S. VC-backed Companies<sup>1</sup>**

3Com Corp	Intel Corp
Actua Corp	Intermap Corp
Adobe Systems Inc	Intuit Inc
Advanced Micro Devices Inc	Intuitive Surgical Inc
Affiliated Managers Group Inc	Iuniper Networks Inc
Akamai Technologies Inc	KLA-Tencor Corp
Alexion Pharmaceuticals Inc	Lam Research Corp
Alphabet Inc	Level 3 Communications Inc
Altera Corp	Linear Technology Corp
Amazon.com Inc	LinkedIn Corp
Amgen Inc	Maxim Integrated Products Inc
Apple Inc	Micron Technology Inc
Applied Micro Circuits Corp	Microsoft Corp
Ariba Inc	Millennium Pharmaceuticals Inc
Ascend Communications Inc	ModusLink Global Solutions Inc
Avis Budget Group Inc	NetApp Inc
Bed Bath & Beyond Inc	Netflix Inc
Biogen Inc	NVIDIA Corp
Biomarin Pharmaceutical Inc	Oracle Corp
BMC Software Inc	Palm Inc
Broadvision Inc	Paychex Inc
Caremark Rx Inc	Peoplesoft Inc
Celgene Corp	PMC-Sierra Inc
Cerner Corp	Red Hat Inc
Chipotle Mexican Grill Inc	Regeneron Pharmaceuticals Inc
Ciena Corp	Ross Stores Inc
Cisco Systems Inc	salesforce.com Inc
Citrix Systems Inc	SanDisk Corp
Compaq Computer Corp	Sanmina Corp
Concord EFS Inc	SBA Communications Corp
Costco Wholesale Corp	Siebel Systems Inc
Dell Inc	Solectron Corp
DoubleClick Inc	Staples Inc
eBay Inc	Starbucks Corp
Electronic Arts Inc	Stryker Corp
EMC Corp	Sun Microsystems Inc
Facebook Inc	Symantec Corp
FedEx Corp	Tellabs Inc
Fiserv Inc	Tesla Motors Inc
FleetCor Technologies Inc	TripAdvisor Inc
Foundry Networks Inc	Twitter Inc
FreeMarkets Inc	Under Armour Inc

Genentech Inc	Verisign Inc
Genzyme Corp	VERITAS Software Co
Gilead Sciences Inc	Vertex Pharmaceuticals Inc
Groupon Inc	VMware Inc
HCA Holdings Inc	Whole Foods Market Inc
Illumina Inc	Workday Inc
Immunex Corp	Xilinx Inc
Incyte Corp	Yahoo Inc

Note: This table lists the 100 VC-backed companies with the largest all-time market capitalizations.

successful business. A busy venture capital professional's most precious asset is time. These days, a business concept needs to address world markets, have superb scalability, be made successful in a reasonable timeframe, and be truly innovative. A concept that promises a 10 or 20 percent improvement on something that already exists is not likely to get a close look. Many technologies currently under development by venture-backed companies are truly disruptive technologies that do not lend themselves to being embraced by larger companies whose current products could be cannibalized by this. Also, with the increased emphasis on public company quarterly results, many larger organizations tend to reduce spending on research and development and product development when things get tight. Many talented teams have come to the venture capital process when their projects were turned down by their companies.

### Common Structure — Unique Results

While the legal and economic structures used to create a venture capital fund are similar to those used by other alternative investment asset classes, venture capital itself is unique. Typically, a venture capital firm will create a Limited Partnership with the investors as LPs and the firm itself as the General Partner. Examples of LPs include public pension funds, corporate pension funds, insurance companies, family offices, endowments, and foundations. Each "fund," or portfolio, is a separate partnership. A new fund is established when the venture capital firm obtains necessary commitments from its investors, say \$100 million. The money is taken from investors as the investments are made through what are referred to as "capital calls." Typically, an initial funding of a company will cause the venture fund to reserve three or four times that first investment for follow-on financing. Over the next three to eight or so years, the venture firm works with the founding entrepreneur to grow the company. The payoff comes after the company is acquired or goes public. Although the investor has high hopes for any company getting funded, only one in six ever goes public and one in three is acquired.

### Economic Alignment of All Stakeholders — An American Success Story

Venture capital is rare among asset classes in that success is truly shared. It is not driven by quick returns or transaction fees. Economic success occurs when the stock price increases above the purchase price.

<sup>1</sup> *The Economic Impact of Venture Capital: Evidence from Public Companies*. Will Gornall, Sauder School of Business, University of British Columbia; and Ilya A. Strebulaev, Graduate School of Business, Stanford University and National Bureau of Economic Research.

When a company is successful and has a strong public stock offering, or is acquired, the stock price of the company reflects its success. The entrepreneur benefits from appreciated stock and stock options. The rank and file employees throughout the organization historically also do well with their stock options. The venture capital fund and its investors split the capital gains per a pre-agreed formula. Many college endowments, pension funds, charities, individuals, and corporations have benefited far beyond the risk-adjusted returns of the public markets. At the same time, the risk capital that funds startups can bring benefits to local economies in the form of company growth, competitiveness, and job creation.

### **Measuring the Impact Beyond Financial Returns**

While venture investing has generated billions of dollars for investors and their institutions, the impact of venture-backed companies has been even more far-reaching. Many venture-backed companies have scaled, gone public, and become household names, and at the same time have generated high-skilled jobs and trillions of dollars of benefit for the U.S. economy. According to a recent study, *The Economic Impact of Venture Capital: Evidence from Public Companies*, three of the five largest U.S.

public companies by market capitalization—Apple, Google, and Microsoft—all received most of their early external funding in the form of venture capital. The study also analyzed on a larger scale the impact venture-backed companies, as a subset of all U.S. public companies founded after 1974, have had on the economy. Of the 1,339 U.S. public companies founded after 1974, 556 (or 42%) are venture-backed. These 556 companies represent 63% of the market capitalization and 85% of total research and development of the post-1974 public companies.<sup>1</sup>

### **What's Ahead**

Much of venture capital's success has come from the entrepreneurial spirit pervasive in the American culture, financial recognition of success, access to good science, and fair and open capital markets. It is dependent upon a good flow of science, motivated entrepreneurs, protection of intellectual property, and a skilled workforce. The nascent deployment of venture capital in other countries is gated by a country's or region's cultural fit, tolerance for failure, services infrastructure that supports developing companies, intellectual property protection, efficient capital markets, and the willingness of big business to purchase from small companies.