VC JOURNEY EXPLAINED:
PLAN YOUR STEPS AHEAD

KUSHIM

Founders note

Clément Aglietta

Co-Founder & CEO Kushim

Dear readers, at Kushim, our goal is to empower investors in their everyday by building the best software solutions for investment management. We enable investors to spend less time doing manual busywork and more time on work that has real added-value, which is to meet founders and to help them build the next big thing.

The journey of Kushim started four years ago and, today, we work closely with leading VC and PE companies from over 25 countries around the world. Investment management is not simply a one-time deal but a long-term strategic process. At Kushim, we are committed to helping investors make the most out of this process. Our industry experience has allowed us to learn and to evaluate the do's and don'ts of investment management, which we summarize in this handbook.

We are pleased to introduce the Kushim Guide to Venture Capital, a practical handbook for investors and emerging market fund managers, to share best practices for investment management. In this guidebook, we explain and exemplify the four pillars in investment management: fundraising, dealflow, portfolio management, and exit.

Clément Aglietta

Co-Founder & CEO Kushim

Author's note

Gautam Kumar

Venture Capital Research & Strategy at Kushim

Dear Readers, there is a gamut of content available on the internet and about raising funds from VCs. Yet, there are few content available that targets the perspective of VCs. In the past five years we have seen more emerging managers getting into the VC game and an increase in number as well as size of investments globally. The deal sizes are getting larger and there is an increasing number of unicorns every year. In 2018, more than 260 Corporate Venture Capital funds were established. The Angel Capital Association of US along with Wharton School of Business estimated that every year around $24 Billion was invested by Angels in the US alone. It is apparent that we have more angel investors, emerging VC fund managers and corporates diving into the early stage investment landscape. This ebook is an attempt to fill the gap of providing resources for investors and limited partners.

In one line, this book is a collection of resources I have compiled by going through more than 30 research reports and 20 academic research papers and posts by VCs. The book is structured in five sections-Limited Partners, Fundraising, Investing, Managing & Monitoring and Exit. I am extremely thankful to Kushim for giving me this opportunity to publish my ideas and my special thanks to Josselin Le Bail- Co Founder and Product Owner at Kushim who employed his unparalleled prowess in designing to design this Ebook. Last but not the least, Clément Aglietta- CEO of Kushim and Oana Manea- CBDO Kushim for continually motivating and encouraging me. I hope you gain new perspectives about the industry from this book and for more high quality content on the industry and resources visit our website.

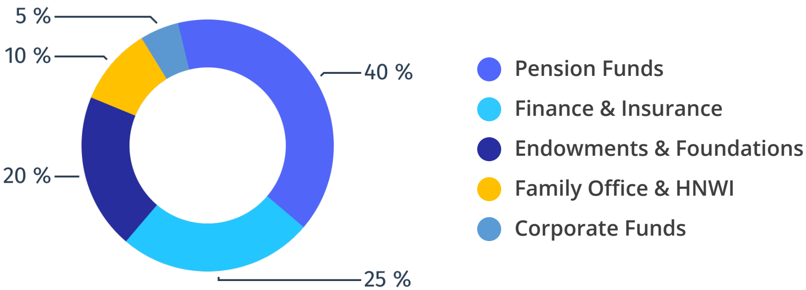
Table of contents

The Limited Partner perspective

1.0 The Limited Partner Perspective

Before we delve into the nitty gritty of fundraising and some tips for new VCs, let's first understand the mindset of LPs. Venture Capital comes under the alternative asset class. LPs have an investment criteria where they choose target investments in each asset class and prepare an asset allocation strategy which is basically a set of investment principles and portfolio construction guidelines.

The risk-return philosophy is the usual one of minimizing risk and maximizing returns. The figure below shows a breakup of LPs for a typical VC fund.



Adapted from: *The Business of VC 2nd Edition (2012)*

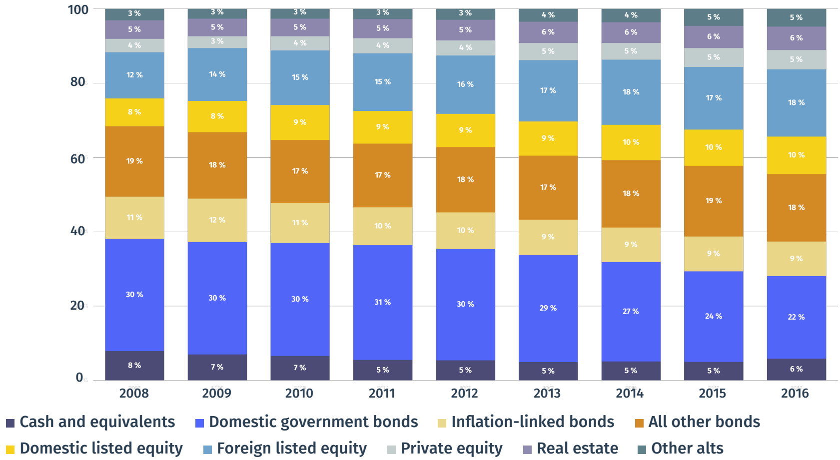
Majority of new funds receive funding from individuals and family offices as they don't grasp the attention of institutional investors. LPs invest in four main asset classes, equity, debt instruments, cash equivalents and alternative investments. Every investor has a different risk appetite, however venture capital is not the most attractive asset class for investors for a number of reasons. Firstly, it doesn't offer the liquidity equity investments offer. Secondly, there is high management fee along with additional expenses regulatory issues and the lack of control. On average investors allocate 20% of their investment into alternative assets and about 7% into venture capital. Over the years, VC funds have captured the interest of LPs but LPs will always prefer to invest in a similar asset class which offers more liquidity, lower fees and better returns.

1.1 Types of LPs

Pension Funds: They are the largest source of funding for VC funds. The primary objective of pension funds is to provide financial security to the employees and their families/beneficiaries. The allocation strategy of pension funds depends on the cash requirements, as they have to pay back a definitive amount to retirees. Due to this cash demand, the pension funds allocate a major portion of their assets to public equities to have liquidity. About 6-12 percent of the funds are allocated to alternative asset class. The figure below shows the average asset allocation of public pension funds in the US from 2008-2016.

Figure: Average asset allocation among PPFs, 2008-2016 (%)

% of total assets, average PPF ***Source:*** *State Street Global Advisors, April 2018*

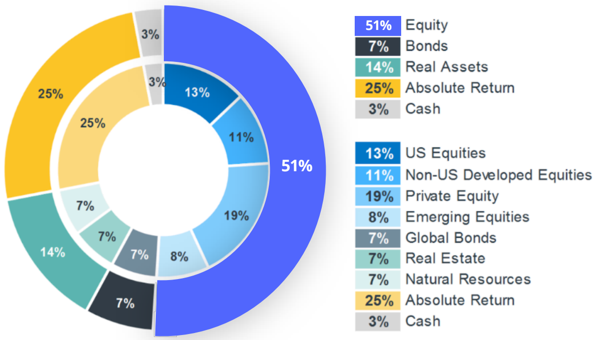


Financial Institutions: The LPs under this category are banks, non banking financial corporations and fund of funds. The asset allocation strategies of each entity depends on their investment horizon, consideration for market volatility.

Corporate funds: Corporations are also one of the LPs. Here we are not talking about corporate venture funds that are established by corporates as a related to stand alone entity. However, the corporate funds just allocate 2-4% of their assets to VC funds.

Endowments: Colleges and universities fulfil their future funding requirements using endowment funds that are non-taxable vehicles. Endowment funds receive funding from gifts, legacies and investment returns. The typical investment strategy consists of diversifying the portfolio with a long term investment horizon. Since they have a long term investment strategy, they invest in alternative assets more than pension funds do. The graphic below shows the asset allocation of top five US Endowment funds.

Chart 1: Asset Allocation of the top US Endowment Funds > $ 1billion 2016



Source: *US University Endowment Reports 2017*

Fund of funds: In layman terms, fund of funds is a fund that invests in other funds. It is an indirect form of investment which address the diversification needs of large institutional investors. The cost associated with a FoF is lesser than investing in a typical PE or VC fund. Typically FoF's allocate 30-40% of their assets to VC funds.

High Net Worth Individuals and Family Offices: Family offices are corporations that are owned by one or more than one wealthy family. In recent times, family offices are taking more interest in VC funds and the allocation across alternative asset class is increasing. The figures below show the break-up of asset allocation of family offices across the board.

Foundations: Just like endowments, foundations allocate a major portion of their investments in alternative asset classes. The objective of foundations are to support charitable and non profit initiatives. In the US, the foundations are governed by federal laws and are regulated by the United States Internal Revenue Service. The foundations usually tend to causes that are not supported by the US government such as climate and environment, childcare, religious and social causes. There are two types of foundations: private and community.

As per the IRS, private foundations in the US have to give away 5-8% of their assets as grants to meet the eligibility criteria. Hence, the remaining portion is invested across different asset classes.

Between foundations and endowments, the short term cash flow requirement for foundations is much less. Hence, they allocate a major portion of their investments to alternative asset class. The figure below shows the average asset allocation strategies adopted by private and community foundations.

	Private Foundations		Community Foundations	
	FY2017	FY2016	FY2017	FY2016
U.S. equities	24%	24%	29%	33%
Fixed income	9	8	14	14
Non-U.S equities	21	19	24	22
Alternative strategies	43	45	27	25
Short-term securities/cash/other	3	4	6	6

Source: *Council on Foundations-Commonfund Study Position Private and Community Foundations for Future Mission Support 2017.*

Insurance Companies: The business of insurance companies is managing risk. Customer of an insurance company pays upfront and sometime in the future the customer may or may not receive the benefits. Insurance companies make money by investing the amount of money they have from their customers which is just sitting around. This sitting money which is waiting to be paid at a later date is known as float. Insurance companies do however have to maintain a certain level of cash at all times to fulfill requirements of solvency.

Insurance companies continually model different types of risks to manage their liquidity position. Since the cash outflow for insurance companies is not certain, they tend to allocate more capital in riskless instruments such as bonds. Hence, VC funds are one of those instruments that get a small allocation by insurance companies.

The figure below shows the allocation strategy of different insurance companies

Total U.S. Insurance Industry Cash and Invested Assets by Asset Class and Insurer Type, Year-End 2017 (BACV$ in millions)

Asset Class	Total	P/C	Health	Fraternal	Title	Total	% of Total
Bonds	2,982,586	1,003,354	116,948	106,703	4,858	4,214,449	65,3%
Common Stock	166,027	598,478	37,510	4,486	2,460	808,692	12,5%
Mortgages	477,051	18,119	134	11,583	81	506,968	7,9%
Schedule BA (Other Long-Term Assets)	177,694	159,418	11,312	4,783	210	353,416	5,5%
Cash & Short-Term Investments	105,008	117,258	46,189	2,925	1,196	272,575	4,2%
Contract Loans	129,027	3	-	2,884	-	131,915	2,0%
Derivatives	58,661	233	1	48	-	58,942	0,9%
Real Estate	23,550	12,849	5,544	286	227	42,457	0,7%
Securities Lending (Reinvested Collateral)	16,870	4,476	724	571	-	22,640	0,4%
Other Receivables	11,652	9,785	652	67	5	22,161	0,3%
Preferred Stock	10,514	5,522	454	612	402	17,504	0,3%
Total	**4,158,640**	**1,929,496**	**219,468**	**134,946**	**9,440**	**6,451,989**	**100%**
% of Total	**64,5%**	**29,9%**	**3,4%**	**2,1%**	**0,1%**	**100,0%**	

Source: *Capital Market Special Report 2017 by National Association of Insurance Commissioners (US)*

High Net Worth Individuals and Family Offices: Family offices are corporations that are owned by one or more than one wealthy family. In recent times, family offices are taking more interest in VC funds and the allocation across alternative asset class is increasing. The figures below show the break-up of asset allocation of family offices across board.

Asset Class	Total	Region				Strategy			AUM $ USD		
		Europe	N.America	APAC	EM	Growth	Balanced	Preservation	<250m	251m-1bn	>1bn
Bonds	**16%**	**16%**	**15%**	**15%**	**24%**	**13%**	**15%**	**23%**	**12%**	**18%**	**15%**
Developed-market fixed income	13%	13%	14%	8,4%	16%	10%	11%	19%	8,1%	15%	13%
Developing-market fixed income	3.2%	2.5%	1.3%	6.9%	8.4%	3.3%	3.1%	3.3%	3.8%	2.6%	1.9%
Equities	**28%**	**25%**	**31%**	**28%**	**25%**	**25%**	**31%**	**27%**	**24%**	**28%**	**29%**
Developed-market	22%	21%	27%	14%	16%	18%	24%	22%	16%	24%	22%
Developing-market	6.0%	3.9%	4.5%	14%	8.7%	6.6%	6.6%	4.5%	8.0%	4.4%	6.4%
Alternative Investments	**46%**	**50%**	**46%**	**41%**	**37%**	**54%**	**43%**	**41%**	**53%**	**43%**	**49%**
Private equity, direct investments	14%	14%	14%	15%	12%	19%	14%	6.6%	16%	14%	17%
Private equity funds	7.6%	7.0%	9.9%	4.9%	6.3%	9.1%	8.0%	5.3%	7.9%	7.2%	11%
Real estate direct investments	17%	23%	13%	18%	9.2%	19%	14%	20%	23%	15%	11%
Hedge Funds	5.7%	5.0%	7.4%	1.6%	8.6%	5.4%	5.1%	7.0%	5.3%	5.2%	8.0%
REITs	1.1%	0.4%	1.5%	2.3%	1.3%	1.2%	1.0%	1.4%	0.8%	1.1%	1.7%
Commodities	**3.3%**	**2.9%**	**3.4%**	**3.7%**	**4.5%**	**2.4%**	**3.2%**	**4.6%**	**2.6%**	**4.1%**	**1.3%**
Agriculture	**1.8%**	**1.4%**	**1.7%**	**2.2%**	**3.3%**	**1.2%**	**1.9%**	**2.2%**	**1.4%**	**3.0%**	**0.5%**
Other commodities	0.7%	0.4%	1.2%	0.1%	0.8%	0.4%	0.6%	1.1%	0.7%	0.5%	0.5%
Gold	0.9%	1.1%	0.5%	1.4%	0.4%	0.8%	0.7%	1.3%	0.6%	0.6%	0.3%
Cash or equivalent	7.0%	6.8	4.7%	12%	9.6%	5.1%	9.1%	5.5%	9.0%	7.0%	5.4%

Source: *UBS Global Family Office Report 2018*

Fundraising

2.1 The Basics of Fundraising

Now that we have developed an understanding of different LPs, let's move on to the fundraising phase. Fundraising is the first process in the managerial aspect of a VC. It is also considered to be one of the toughest activities as General Partners have to convince investors to lock in huge sums of money for a long period of time. The time period is usually ten or more years.

Fundraising can be divided into four stages. If the fund is based in US or UK then there is another step of raising debt:

1- Creation and testing of investment idea
2- Selling the investment idea to LPs
3- Debt raising
4- Closing the fund

Creation and testing of investment idea: The investment idea is not the final investment thesis of a VC fund. The investment idea phase where the GPs are testing the viewpoint of potential LPs whether or not they are interested in investing in a fund that focuses on a particular industry. A process commonly known as 'testing the waters' takes place where, in an informal way, GPs test the interest of potential LPs.

Let's illustrate this with an example: suppose you are an aspiring general partner who has more than a decade of experience in the mobility sector. Now, you want to raise money for your fund focused on investing in startups providing urban mobility solutions. You must conduct informal query to find out whether investors are interested in urban mobility solutions. If not, then you have to change your business idea and focus on another segment that interests the investors. On the other hand, the investment thesis is a detailed set of parameters the fund adopts for investing. For instance, the investment thesis can be described in the following way- A $20Mn fund with additional fee of only $1.5 Mn over the course of ten years with no management fee but 20% carry. Focus on early stage post revenue SaaS companies based around New York City. Average cheque size will $200,000 and the fund will make 10 investments every year. Additionally, the fund will also provide office space to founders and partners with extensive experience in scaling SaaS companies will provide mentorship. If testing of waters is positive then the GPs can draft the business idea in a formal way by preparing the 'information memorandum'. This document is a set of slides where the GPs describe the characteristics of the fund i.e. the fund size, amount of management fee, carried interest characteristics and the mechanism to manage the portfolio. Once the investors approve the information memorandum, the next step is to transform the information to a Limited Partnership Agreement. However, the process is somewhat different in the European Union compared to US and UK. In the European Union, after the investors have expressed their positive sentiments, the GPs are required to get an approval from the supervisor of asset management company. After getting the approval the information memorandum is now converted to a document called internal code of activity.

In the United States and United Kingdom, no such approval is required and the information memorandum is converted to a limited partnership agreement.

Selling the investment idea: Now the GPs or managers must try to sell their idea and have the investors sign the letter of commitment and invest their money to the VC fund. This process is private and confidential in nature. GPs organize one to one meet up with HNIs (High Net worth Individuals) institutions like insurance companies or investment banks. Sometimes the GPs can also meet multiple investors in meetings rather than just organizing one to one meetings with every prospective investor. Depending on the origin of a fund, there is one more step of debt raising which is relevant only if the fund is originating in the US or the UK.

Raising Debt: This is one of the phases which presents a dichotomy. The GPs in the US and UK must convince banks to finance money to their fund not as investors but as lenders. The dichotomy here is that GPs must convince bank to become lenders as the investors would want to know whether the banks are in and on the other hand before lending the money the banks would want to know whether the LPs have committed their money to the fund. Obviously, in this case, the reputation of the GP plays a crucial role. Better the reputation and track record of GP, easier is the process of getting debt and LPs onboard.

Closing the fund: In Europe the fundraising on average lasts for one and a half years while in the US and UK it typically lasts for a year. If the GPs are able to raise all the money as they set out to then the VC fund is successfully closed and now it is ready to invest. However, if the GPs are not able to raise then the outcome is negative and the fund is literally closed meaning that the GPs failed in the fundraising activity.

2.2 Fundraising for new VCs

Fundraising is a daunting task for any VC but it is even harder if you are raising a fund for the first time. On average it takes approximately 18 months to raise a fund. Sometimes it can take more than 500 meetings to convince just a couple of LPs to commit their money. The LPs are always looking to see some traction before they commit their money. This also represents a vicious cycle as you need some form of funding to show traction but at the same time you don't have any money. One way to navigate such circumstances is to focus on growth prospects and having a differentiator. You can do so in the following ways:

Investment Thesis

The investment thesis can act as a strong differentiator if done right. There are numerous VCs out there with different value propositions. A good practice is to conduct a market analysis to identify the emerging and unserved sectors. A caveat here is that, you must also take into account whether you have some specific competencies to win in that industry.

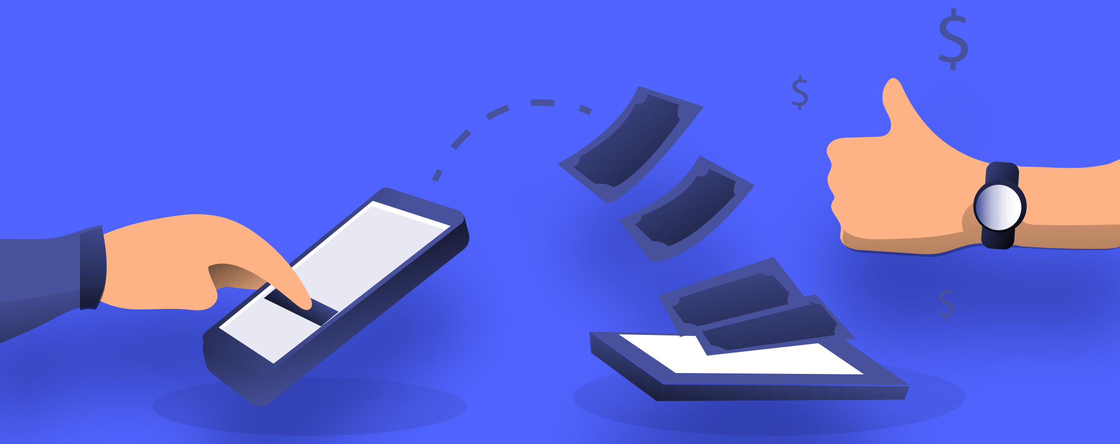
The Return Focus

Eight out of ten investments fail and only two produce extraordinary returns. Your returns have to be more than market indices such as S&P 500, Dow Jones or the German DAX. Most of the asset managers invest a small portion of their portfolio on VC funds. Hence, they have to justify investing in your fund. Another question you must think about is why should the LPs invest in your fund rather than the fund of some other prominent VC which has more than 30 years of investment experience.

Defining your investment vehicle

Most of the traditional funds have a LLC GP structure for the GPs managing the fund and a Limited Partner agreement with the fund itself. For inexperienced investors, it is a good idea to participate in syndicates and by joining AngelList Syndicates or FoundersClub partnerships. Even new CVC funds must think about participating in syndicates or doing co-investments.

Investing



3.1 The Concept of Capital Call

LPs of a VC fund commit a sum of money but they don't give away the entire sum in one go. A letter of commitment is signed between the VC firm and the LPs whereby the VCs can call a portion of the committed money. One question which arises at this point is why LPs don't give away the entire sum in one go? This is because of the VC model of investment. The typical investment period is 3-5 years but during the investment period VCs are always evaluating companies for investment. Therefore, the entire sum committed by an LP is not invested in one go. Another reason is that calling the complete capital in the beginning will decrease the fund's performance and cause what is known as "cash drag". This phenomenon is described the example given below:

CASE I: No Capital Call

In this case, the fund receives entire $150 Million in the beginning and invests a portion each year and receives $450 Million after selling all investments at the end of year eight.

Time	0	1	2	3	4	5	6	7	8
Capital Call	-150	0	0	0	0	0	0	0	
Proceeds									**450**
IRR	15%								

The IRR in this case is 15%.

CASE II: Capital Call

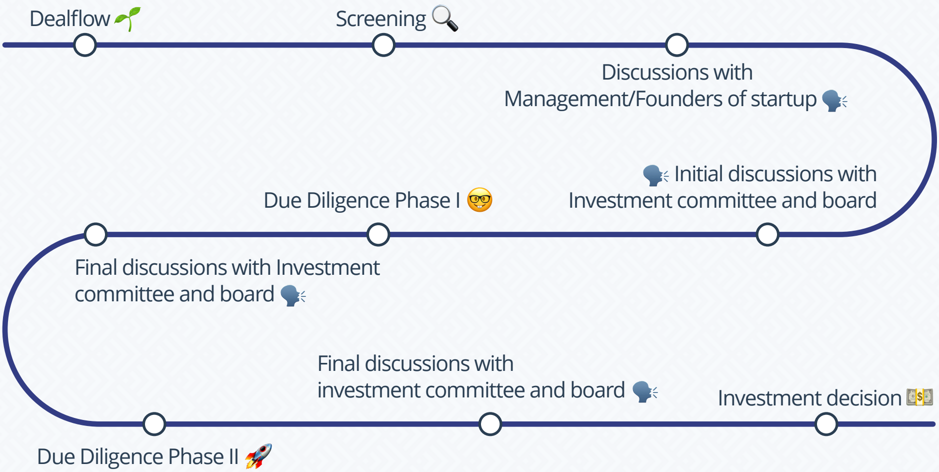
In this case, the VC firm will call for capital when it is about to make an investment.

Time	0	1	2	3	4	5	6	7	8
Capital Call	-25	-30	-30	-35	-20	-10	0	0	
Proceeds									**450**
IRR	20%								

The IRR in this case is 20% which is higher than the previous case where there was no capital call.

3.2 The Investment Process

The investment process can be broken down into following parts:



The first step after raising funds for VCs is to create a dealflow. There are two ways in which VCs create dealflow- directly and indirectly. VCs have forms on their website where they receive submissions from startups and they also get submissions from their contacts in the statups ecosystem. An efficient way to build up dealflow is to leverage the network of VCs. It can be done by forming a network ecosystem with the founders, VCs have already worked and ecosystem builders.

Certain organizations and individuals act like "ecosystem builders", these organizations or individuals are well connected with founders of different startups and continually strive to connect various stakeholders of the startup ecosystem. Indirectly, VCs generate dealflow through investment bankers, brokers, consultants, accountants and advisors. On a day to day basis, VC analysts and associates are going through databases like crunchbase reading about latest developments through venturebeat, techcrunch to find investment opportunities.

3.2 The Investment Process

VCs screen all the pitchdecks they receive and use pointers such as stage of business, geography, business model, revenue, industry, team, patent to find startups that fit their investment thesis. While making pitchdecks, founders must understand that a pitchdeck is not a business plan of a startup, it is like a teaser to get a meeting from the VC. All the pitchdecks that pass the screening process are then contacted by the VC for more information.

The figure below shows common screening pointers used by VCs to screen startups:

		Requirements	Remarks
Business Factors	Stage of Business	Seed/Series A	Some VC focus on just Series B+ invest.
	Revenue status	Post Revenue	
	Business Model	Completely defined $1 billion+	
	Market Size (unit	$200 Million+	Some VCs also focus on rapidly growing markets that might be in multi millions
	terms)	25% Q-o-Q	Varies from industry to industry
	Historical Growth	Yes or Patent Pending	Varies from industry to industry
	Patent	Difficult	
	Difficulty of imitation	Strong	Moat refers to a company's ability to sustain its competitive advantage
	Moat	Many	

Team Factors	Vision of Team	Strong
	Track Record of Team	Proven
	Founder/Management	Strong
	Leadership	
	Technical Team	Strong
	Sales Team	Strong

Risk Factors	Industry Risk	Low/Moderate
	Execution Risk	Low/Moderate
	Legal Risk	Low
	Dilution Risk	Low
	Regulatory Risk	Low
	Team Risk	Low
	PR Risk	Low

Strategic Factors	Industry focus	Aligned with Investment thesis	
	Go-to-Market strategy	Strong	
	Business focused	Yes for VCs focused on B2B	B2C cies will be rejected
	Consumer focused	cies	B2B cies will be rejected
	Board seat	Yes for VCs focused on B2C	
	10% Equity	cies	Equity percentage varies from VC to VC
	Prominent Investor	Yes (no for minority investors)	Reputed Angel Investors or a VC is a

Financial Factors	Revenue	$1 Million+	Some VC focus on just Series B+ invest.
	Projected 5-year Revenue	$15 Million+	
	Pre Money Valuation	Less than $20 Million	
	Revenue/Valuation Multiple	<10x	Some VCs also focus on rapidly growing markets that might be in multi millions
	Projected return	4X+	Varies from industry to industry
	Cash Burn	12 Months+	Varies from industry to industry
	Gross Margin	50%+	
	Capex Requirement	Low to Moderate	Moat refers to a company's ability to sustain its competitive advantage
	Cashflow Positive	Yes	
	Future Cash Requirement	Low to Moderate	

3.2 The Investment Process

Internally, VCs create an internal document which contains the minutes of every meeting the VCs have with the management of the startup. This internal document is updated regularly. VCs have an investment committee that comprises of individuals with vast sector specific experience, investment experience and have decisive powers to decide whether the VCs will investment in a firm. In addition to an investment committee there is also a supervisory committee that represents the interest of the limited partners. In most cases, the supervisory committee has an advisory role rather than a decisive role. The first phase of due diligence is done by the VCs internally. VCs use their previous industry/ investment experience to assess the viability of the investment. The first term sheet is also presented to the management of the company. This is not a definitive term sheet as amendments can be made later on. At this stage the VCs have not incurred any additional cost pertaining to due diligence.

The findings of internal due diligence along with the discussed term sheet are presented to the investment committee and the supervisory board. The investment committee can either reject the investment proposal or ask for information. At this point, the VCs also prepare a budget for the second phase of due diligence which is external due diligence. In external due diligence, VCs consult with accountants, lawyers, ambassadors and auditors to perform thorough due diligence of the investment opportunity. The VCs also ask the management of the startup to provide a range of legal documents. The number and types of questions along with the documents will vary from case to case basis. During this phase, term sheet negotiations also go on.

After the second phase of due diligence, VCs present all gathered information to the investment committee and the committee decides whether to go for the investment or reject it. Once the investment committee is satisfied and gives a green light to investment, the VCs negotiate the final term sheet and make preparations for capital call to make the investment. VCs send the capital call document to their LPs requesting the requisite amount of money. Typically it takes 10-15 days for the VCs to receive the money. As the final term sheet is executed, lawyers begin drafting documents such as:

Investor Rights Agreement (IRA): This includes registration rights, preemptive rights, affirmative covenants, negative covenants. Affirmative covenants means the actions that the company should take such as paying taxes, maintaining accounts, managing the company etc. Negative covenants pertain to actions that the company must avoid such as engaging in unlawful transactions with outside parties, making investments or taking risks that incur significant debt for the company etc.

Share purchase agreement: This includes all purchase details, board compositions, voting rights, company's representations and warranties.

Managing and Monitoring

Once the investment is made in a company, the job of VC is now to identify, create and sustain value for the portfolio company by taking a board seat. Before VCs take a board seat, one of the most important considerations is that the VC must have adequate expertise to steer the company forward while navigating the challenges. Additionally, there are some more vital points VCs must consider when they take a board seat:

- Have a thorough understanding of the business and industry including knowledge about the customers, suppliers, competition and threat.
- Have an understanding of the present structure of the board and the role VC will play as a board member.
- Have a clear idea about the current financial status and requirements of the company such as the cash burn rate, user acquisition costs and sales cycles.
- Be well aware of the company's challenges and milestones to be achieved in the next 12-16 months.
- The internal challenges of the company from the perspective of the board members such as the power dynamics, product development strategy, go to market strategy etc.
- The external challenges of the company from the purview of the board such as compliance for taxes and regulations, employment laws and other legal matters.

North Coast
TECHNOLOGY INVESTORS

"As a board, your role is to prove the business plan and your only two control levers are the CEO and the budget"

Lindsay Aspegren, *founder of North Coast Technology Investors comments on the role of VCs as board members.*

4.1 Duties of VC Board Members

The figure below shows the requirements and strategy board members should adopt in accordance to the stage of portfolio company:

Board functions	Seed-Early Stage	Growth Stage	Mature Stage
Board focus	Product development	Revenue Increment	Growth Management
Average number of board members	Two to four	Three to six	More than six
Key metrics	Cash burn, development cost, product launch time	Sales cycle, marketing efficiency, cost, revenue, break-even	EBITDA, capiral structure, gross margins
Board member requirements	Relevant technical expertise to assist in product development	Sales & marketing, operations, HR	Investors relations, legal, management, executive recruitment
Strategic focus	Experimentation	Expansion	Control
Corporate governance	Creating financial reporting & management system, overseeing legal & shareolder agreements	Creation of risk management, cost control systems, assigning compensation for various committees	Guiding company to IPO, managing public company, naming directors, establishing internal control systems and assist in strategic planning

Adapted from: *Working Group on Director Accountability and Board Effectiveness, « A simple guide to the basic responsabilities of a VC-Backeck company director » by Levensohn Venture Partners*

A white paper by Working Group on Director Accountability and Board Effectiveness, titled 'The Basic Responsibilities of VC Backed Company Directors" outlines a framework of responsibilities for VC board members. The duties are mentioned below:

Confidentiality Duties: This simply requires the board members to maintain confidentiality with regards to non-public information about the company.

Disclosure related Duties: These duties require the board members to disclose and provide all necessary information about the company to the shareholders of the company.

Duties of fair judgement: This duty is based on the presumption that the board members, when taking business decisions have acted on all available information and have acted in the best interest of the company and the shareholders.

Duty of loyalty and care: Simply, this duty requires the board member to act in the best interest of the company and not partake in activities that would produce significant benefits to the board member at the expense of the company. Furthermore, the board members are required to obtain necessary information and make due inquiry to act in the best interest of the company.

4.1 Duties of VC Board Members

One of the major drivers for growth and sustainability for a company is good governance. In practice it is often ignored or the board members take rash decisions that have catastrophic outcomes. Board members have to be vigilant, engaged and flexible. Being engaged doesn't mean pestering the management for constant updates, which is often times not a fruitful style of management nor is micromanagement.

4.2 Board Value Creation

Board members don't have a magic wand which they wave and value is created for the company. However, there are many ways in which board members can create value for the portfolio companies. Hence, it is essential for the VC firm to appoint a board member who can provide the maximum value to the portfolio company. VC board members create value in the following ways:

Recruitment: Board members are responsible for appointing the CEO and also recommending individuals for top management positions.

Financing: With regards to financing, VCs help the management of the company with financial management, especially cash management and assist in further rounds of financing.

Governance: This is already discussed in the previous section but the importance of good governance has to be stressed more. NYU Stern's Prof. V. Acharaya in his research study on corporate governance and value creation concluded that GPs of best performing PE firms in UK actively managed their portfolio companies and created value.

Business Development and Introductions: Experienced board members who have deep industry contacts can help portfolio companies in getting new customers, new suppliers or vendors and make introductions with key stakeholders that would be normally outside the reach of the portfolio company.

Strategy: This is also one of the significant values board members bring to the table. Board members can help the management of portfolio company with regards to go to market strategy, product development strategy and marketing strategy.

4.3 Boardroom Dynamics

In the previous sections, I talked about the importance of good governance and what VC board members need to know to govern a company better. It is easier said than done in practice. There are multiple perspectives at play which make the boardroom challenging. There is a dichotomy with respect to control-startups do not follow the top-down level of management but as a board member it is essential for the board to have a top down approach to managing the company. Hence, board members have to strike a balance in between.

CEOs do not approve of those young VC board members who try to assist them in functional strategies such as marketing strategy whereby the VC board member having no entrepreneurial experience keeps on objecting to the marketing strategy proposed by the management of the company by requiring more analysis of probable adverse scenarios.

In situations where the company is consuming too much cash, the board concludes that the management is not doing a great job. From the surface, it seems like a management problem but there can be many underlying reasons. There can be a clash with regards to dividends to shareholders of the company and bonus to the management.

Another avenue of tension is performance. Many times VCs invest in early stage company and over a short period of time there are possibilities that the revenue doesn't grow as expected. There can be multiple reasons for such a scenario, one can be that there has been an unexpected change in the legal or regulatory framework which requires the product or service to be altered and the process of altering is taking time. The second reason can be that the sales cycle of the company has become longer or the product market fit has changed. There are situations where a particular product targeted towards a specific industry might actually be a fit for another industry. The key here is to identify such 'fit' but in practice it is often not as easy as it sounds.

4.3 Boardroom Dynamics

One of the challenging tasks board members encounter is ‘CEO Transition’. Yujin Chung (Wharton MBA’10) conducted a study to assess whether founding CEOs perform better than professional CEOs. His study revealed that Founding CEOs in SaaS companies add more value than professional CEOs.

Founding CEO’s outperfom Professional CEO’s taking into account situation bias

A Harvard study on 460 US companies from the 2000s era.

Professional CEO tenure likely shorter due to late stage of company at time of hiring

Lower exit valuation relative to implied valuation at

Estimated valuation of startup at last investment round closest to new CEO hiring

Extrapolated valuation when CEO was hired based on linear growth/decline between estimated valuation and exit valuation

For founding CEO, ROI based on first investment valuation and exit

For professional CEO, ROI based on valuation at time of hiring and exit

Ability of Professional CEO to create value function of ability and also inherited difficult state of firm

The study showed that Founders were able to add value by giving up board control and bringing in a professional CEO. Another Harvard study (published HBR 2008) involving 212 US startups that were founded in the time frame 1990s-2000s showed that less than 50% of startups had the founding CEO until the company was three years old. Furthermore, as the ventures were more than four years old, only 40% had founding CEOs still having control and for those companies that went public, only 25% of them had the founding CEOs.

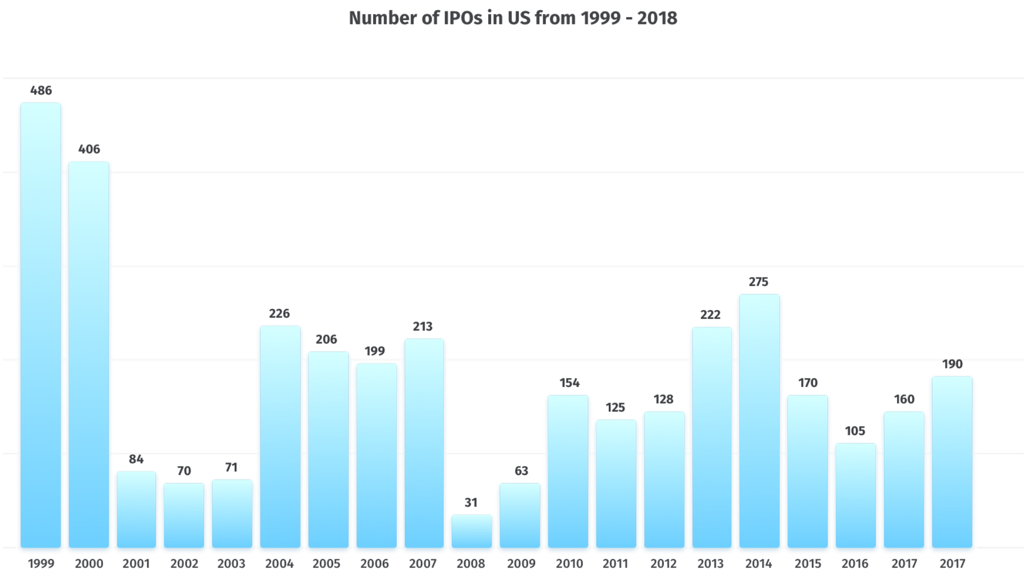
Therefore, there are studies that show that founding CEOs can be the value drivers while taking the company from early stage to successful exit and there are also studies that show the opposing view. Sometimes the founders of a company lose interest in being CEO as the company grows as they are more of a creator than a manager. As discussed in the previous sections, the board must assess the situation and help the company in smooth transition from one CEO to the other.

Managing Exits

5.1 Exit paths

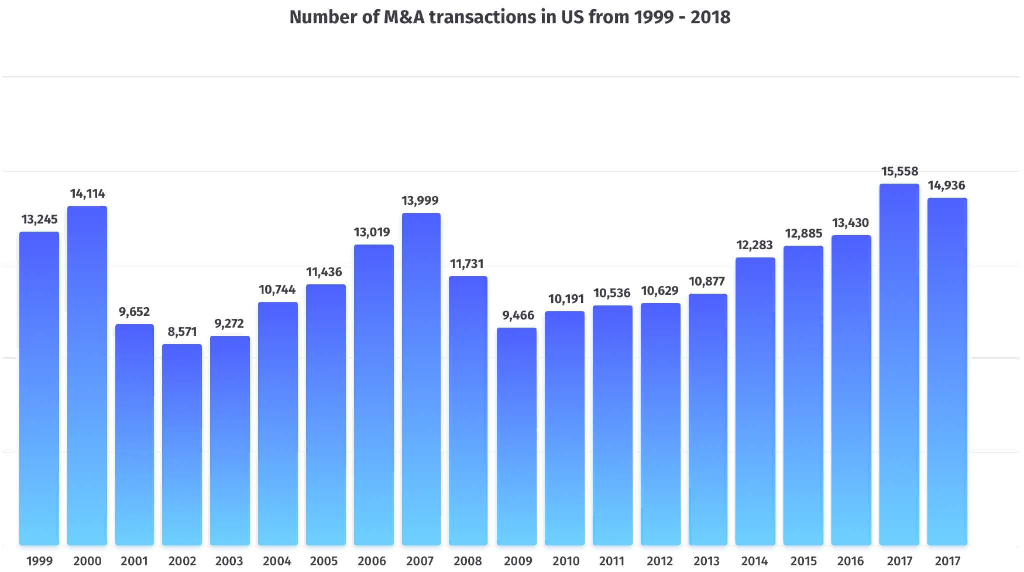
When it comes to exit, there are two primary paths- IPOs and acquisitions.

The figure below shows the number of IPOs from 1999-2018:



Data Source: *Renaissance Capital-US IPO Annual Review 2018*

The figure below shows the number of M&A transactions in the US in the period 1999-2018:



Data Source: *Institute of M&A-US Market 2019*

5.1 Exit paths

Companies that go for IPO are considered to have achieved the pinnacle of success from the point of VCs. Compared to an acquisition, IPOs are more time consuming and costly. They also require the company to follow the set of rules and regulations set out by the Securities and Exchange Commission in the US and similar bodies in other countries. Other than IPO and acquisition, a company can also find buyers on secondary market places.

Secondary market places such as Share Post, NASDAQ Private Market (Formerly SecondPost), Liquidnet, Equityzen assist private companies in finding buyers. The positive aspects related to private marketplaces is that the company can achieve liquidity fast and at higher valuations. However, the company needs to have a reputation and must be considered 'hot' to attract potential buyers. The downside of secondary sales is that the employee morale might go down or there can be more tensions in the management of the company which would subsequently affect the future performance of the company.

5.2 VC considerations for exit

When it comes to exit, successful VCs know when is the right time to make a profitable exit as well as when to leave a failed venture. From the very early stages, VC continually monitor the portfolio value of the company along with the milestones to plan their exit. There are times when a successfully growing company gradually starts showing decline in a short time period. In such situations, sometimes VCs continue to pour in more money to keep the business growing but successful VCs cut their losses and move on. However, in this regard there are some perspectives that come into play. One of the prerequisites is to have alignment of interest of various stakeholders- the board of directors, the common shareholders and the CEO plus management. The exit value of a company can be affected if the management of the company doesn't want to exit or when one or more VCs are under pressure to make an exit while others have a different opinion.

Timing is one of the key determinants of successful exit. There are scenarios where a mature company might not exit, just because there is a belief that the value of the company will rise up. However, in the near future, there is a change in either market or any other external change such as legal and regulatory that diminishes the value of the company. Successful VCs when make an investment, they don't think about just making an exit in three to five years, instead they strive to grow a startup to a company that continually provides value to customers.

Disclaimer

This Ebook provides a set of views about the VC and alternative asset class industry derived from various academic and professional sources. The purpose of this ebook is to provide knowledge about the VC investment industry. Kushim is not a legal firm nor does it provide any form of legal advice to its clients. Hence, this ebook doesn't substitute an attorney's advice for any task related to the investment process i.e. from fundraising, investing, investment management and exit.

The content provided in this ebook should not be taken as absolute or exhaustive piece of information when it comes to the complete process of investing. Effort will be made by the author to update the information such as industry reports cited in this ebook from time to time in future editions of this ebook. Neither Kushim nor the author of this ebook is liable to any form of loss, injury, claim, liability or damages related to your use of the information contained in this ebook. The use of the information provided in this ebook is at your own risk.

www.kushim.vc