

What Venture Capital Can Learn from Private Equity

The venture capital game has changed, yet many VCs are still using an old, outdated playbook

By [Peter Rip](#)

Baseball and venture capital always seem to make an effective pairing for analogies. As in baseball, much of the cachet of venture capital is inspired by the romance of the metaphoric grand slam. The recipe has been the same since venture capital began: Find a team, give it money, sit back, and wait for the bloom. Most investments fail. But a few could be big winners and make it all turn out just fine. It used to be said in this business: "You can only lose one times your money." The implication is that winners will pay back the risk many times over.

The reality is that this approach works for an ever-winnowing number of companies, and shockingly few since 2000. The median venture capital fund has seriously underperformed the Russell 2000 Index since 2000. This is a stunning reversal over the prior two decades. What happened? There was a structural change in the game, yet most of the incumbents kept executing the same playbook.

Traditionally that has meant funding disruptive change and managing execution risk. For example, the decision by [Kleiner Perkins Caufield & Byers](#) to recruit [Eric Schmidt](#) was a masterful way to take the risk out of business execution at Google ([GOOG](#)) early on. Closer to my home, my partner, Jim Feuille, led change in our business model when we invested in [Pandora Media](#), changing from a subscription service to free personalized Internet radio. Today, [Pandora](#) is the largest radio site on the Web. Managing execution risk at Pandora meant adding measured risk to capture the return of a bigger opportunity.

The classic VC play has always been to take enough risks and you'll be rewarded with the Great Exit, such as a big IPO or acquisition. VCs learned to excel at team selection and the mitigation of execution risk, often considering other risks inherently uncontrollable. Venture capitalists tended to place less emphasis on issues such as valuation, the timing of exits, and future capital availability precisely because you could only lose one times your money.

The Bull Benefit

Great Exits happened from 1982 to 2000 with a regular cadence. The strategy of going for the grand slam in every deal in every portfolio worked often enough during that bull market. The bull market gave public companies more currency to buy startups and often instilled public investors with confidence in the future of small growth companies. There were some spectacular successes among many long-forgotten failures.

The bull market in technology ended with a bang in 2000. Nevertheless, most of the venture capital industry still executes the same playbook, ignoring the public market, which is why the industry has performed so poorly since 2000.

Author Michael Lewis chronicled the success of baseball teams such as the 2002 Oakland Athletics in his book *Moneyball*. The A's didn't have the funds to buy top athletes, but instead assembled a winning team through a more analytical approach. Statistical analyses included in the book found that ballclubs that simply tried to get a man on base as many times as possible won more games than teams that focused on hitting home runs.

Most investors in venture capital understand that you cannot generate an acceptable rate of return by hitting singles and doubles. What they don't appreciate is that a strikeout is far more destructive when grand slams are fewer and further between. And with fewer grand slams, time also matters. In a secular bear market, that Great Exit may take so long to occur that the drought destroys your internal rate of return.

More Risk to Manage

In short, it has become clear since 2000 that financial risk/return is as important as execution risk in venture capital. Financial risk/return refers to weighing the risk that the financial markets may not be ripe enough soon enough to justify investing this much, at this valuation, now. Today's VCs have to pick great markets, great teams, and manage execution risk, as they always did. But they also have to manage valuation risk, timing risk, and investor syndicate risk.

Venture capitalists can learn a lot about managing this new set of risks from their counterparts in private equity. Whereas the traditional venture capital playbook has been about company-building, the private equity playbook has been about financial engineering. Private equity is focused on metrics, comparables, terms, and cost of capital—more so than innovation, market selection, and team development. Their teams and companies are more mature, reducing the need to be an expert in assessing execution risk.

Think about this in terms of an inflection point, or that period when an additional dollar invested yields far greater shareholder value than it would have at an earlier phase. It's the point at which a little gas fuels a huge fire. Finding the best companies and investing in them at inflection points are perhaps their two most important disciplines. Stage is not a consideration. It is all about that inflection point.

Venture capital is at the intersection of innovation and finance. Fortunately for investors, innovation continues without regard for the financial markets. The jet engine, the helicopter, FM broadcasting, fiberglass, nylon, photocopying, radar, sticky tape, and instant film were all invented during the Great Depression. Breakthroughs are everywhere today, in energy technology, biotechnology, and even information technology. These innovations will continue to disrupt incumbents and create new markets—and they will all need early-stage venture capital.

But the absence of buoyancy in capital markets means the early bet is not always the best bet. The new venture capital playbook begins by taking into account the macro drivers of growth. Which sectors are most ripe for disruption through innovation? Add to this the venture practice of building networks of entrepreneurs and partners who can place you in the flow of that innovation.

Inflection Points

Here's where the private equity model takes hold. Like private equity investors, VCs need to understand the entire sector, at every stage in the spectrum—seedlings through large public companies—to develop a theory of how the industry will evolve. Who will win and who will lose? When will incumbents need to make strategic acquisitions? What events have to transpire to enable big, new markets?

And, like other forms of private equity, the timing and probability of exits are as critical as their magnitude. This necessarily leads to a view toward finding inflection points, regardless of stage. Sometimes the best stage is the napkin sketch in the coffee shop; sometimes it's the phoenix rising from the ashes of \$100 million of previous investors' capital. Either has the potential for venture capital success. The best performing venture capital investors will be able to find both.

At [Crosslink Capital](#) we have been evolving this new venture capital playbook since the late 1990s. We recognized early on that the bull market was over in 2000. We mostly sat on the sidelines for much of 2001 and 2002 with our 2000 venture fund. When we did return to investing, we did many restarts, turnarounds, and private investments in recently public companies, many of which were in Internet and services. This strategy of selectivity, stage independence, and a focus on companies at inflection has served us well.

Letting Go of the IPO Window

By 2006 we began to see two important shifts with our new venture fund. One was the emergence of energy technology as a new and important growth market opportunity. Many energy technologies had reached a point where the scientific risk was being replaced with commercialization risk. This transition is always a tipping point in the emergence of new growth venture markets.

The other shift was a rising inflation in later-stage valuations. It seemed many of our peers anticipated a forthcoming IPO window, whereas we did not. So we tended to find better values in earlier-stage opportunities, where the return multiples would justify the higher financial and execution risk. A few of these companies have had very attractive subsequent financings,

suggesting we are off to a very good start. Among the companies funded were [Twin Creeks Technologies](#) (energy), [Like.com](#) (search), and [OpSource](#) (cloud computing).

There are lots of strategies for playing to win in baseball and in venture capital. The best strategies are context-specific. Entrepreneurship and innovation are eternal. A few venture firms will be able to continue to successfully swing for the fences without the bull market tailwind. Most will not. Great returns will continue in venture capital, but only for those who can successfully operate across the spectrum of private companies and find great value regardless of their stage.

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