TEN CAPITAL NETWORK

eGuide

How to Raise a VC Fund

www.tencapital.group
info@tencapital.group

Contents

PART I: The VC Life

Challenges of Being a VC

VCs are a form of private equity financing provided by venture capital firms to startups and early-stage companies. They are attractive and many people want to work for a VC, particularly those straight out of college.

However, most individuals are not aware of the challenging dynamics that come along with VC lifestyle.

Here are a few of those challenges:

Raising Funding

Just like a startup, the VC has to raise funds, too. LPs tend to be rear-view mirror oriented and not focused on the cutting edge of new technologies and markets.

Working with Partners

You'll rarely have the chance to make the decisions alone. Rather, you'll be making those decisions with the other partners. Ego and other agendas are often at play, which can be stressful.

Getting Deals Done

You have to convince others you have a winner on deck. You have to sell it all the way through the process.

Managing the Dealflow

Untold numbers of startups want to talk with you. However, only a small fraction of those startups are meeting your funds criteria.

Dealing with Co-Investors

It’s rare for a fund to take the entire round. There are usually other investors in the deal. Who gets how much of the deal and what board seats are often an issue.

Startup Rollercoaster

Things often don’t go well at the portfolio companies and this weighs heavily on the VCs who invested in them.

How VCs Raise and Make Money

Raising Money

VCs raise funding from limited partners which includes:

- family offices
- high networth individuals
- foundations
- pension funds
- other sources

Institutional investors, such as pension funds, require a track record. This means first time VCs focus on family offices and high networth individuals.

In most cases, institutional investors do not like to be more than a certain percent of any one fund due to concentration limits. Typically this is no more than 20%.

The VC develops an investment thesis which is a reasoning why their approach to selecting and funding deals will be successful.

VCs build out their investment prospectus which includes the investment thesis, why it's unique, the fees the limited partners will pay, and how the profits will be distributed.

The VC then meets with limited partners to pitch the investment thesis, track record, and view of the market.

Limited partners look to fund VCs who have a unique investment thesis and access to deal flow they do not.

Making Money

VCs charge the limited partners a management fee on the funds raised. This is traditionally 2% which is paid out every year for the life of the fund.

Some funds stop the management fee around year 6 or 7 as proceeds from the investments start coming in.

MicroVCs often charge 2.5 or 3% of the funds raised since the amount of funds is lower than standard.

The second source is called **carry** and is a percent of any proceeds going back to the investor from the investments.

This is traditionally 20%.

Some funds start taking carry at the beginning of the investment returns while other funds start this after the investor receives their initial investment.

Fiduciaries, Syndicates and Syndication

Fiduciaries

A venture fund brings a fiduciary responsibility to those raising the funds from limited partners.

A fiduciary means:

The VC must act in the best interest of the investors.

VCs who sit on the boards of their portfolio companies also have a fiduciary duty to that company.

There are times when the two fiduciaries come into conflict.

Since conflict can arise, it's best to have your duties to the investors stated in the PPM such as liquidation preferences, preferred shareholder treatment, etc.

The VC must appear to be following a fair treatment of both parties and may need to engage in negotiations to resolve conflicts.

VCs often use incentives such as offering additional equity to either the startup or the fund's investors to resolve that conflict.

For example:

The investors may want to see an exit sooner rather than later, however the startup founders want to wait to potentially gain a bigger exit.

The VC can offer additional equity to the founders if they agree to an exit now.

Syndicates and Syndication

Both angels and venture capitalists often invest in syndicates.

In a syndicate one of the investors leads the round and the other investors follow.

Sometimes the syndicate is a formal group in which the lead investor receives compensation from other investors who join the round.

Angel investors often join syndicates in which they pay a portion of their carry to the lead investor for organizing the deal.

Other times, the syndicate is informal with investors sharing deals with each other for no compensation.

VCs also syndicate deals with each other to help fill out the round as a way of attracting the better deals. They bring not only their own funding but can also attract additional capital.

Funds Held in Reserve

When a Venture Capitalist makes an investment, they place a portion of their allocated investment up front in the first round. The rest is saved for a follow on round.

Most VCs put criteria on the startup's progress before joining the follow on round. This means the startup must achieve milestones such as revenue generated to get the follow on funding.

VCs have:

1. Some of their funds invested in startups
2. Some reserved for follow on rounds on those startups
3. Some funds that are available for new startups

The funds for new startups is referred to as **dry powder**. This is the number you need to know before pursuing a fund because you could spend your time selling an investor that has no money to invest.

The last thing an entrepreneur wants to hear from an investor is:

We'll call you when we raise our next round of funding.

How Can VCs Make More Money and Time Element of Returns

Making Money

It’s helpful to understand the VC investor how they make money. In venture capital, there’s 2 ways to make money.

1. VC’s typically take 1/3 of the equity for their investment.

In rough numbers, the VCs take the amount to be raised and double it for a pre-money valuation. The VC receives equity ownership of investment divided by post-money valuation.

As an example:

Say you are raising $1M.

The VC will turn that into a $2M pre-money and then add the $1M investment to reach a $3M post-money valuation.

The investor receives investment divided by the post-money which is 33% of the equity. That’s how much equity the startup gives to the VC for the funding.

2. The VC charges their investor, called Limited Partners, a fee and carry which is most often a 2% fee and a 20% carry.

VCs have limited bandwidth and can only take on a certain number of deals. They look for startups that will agree to these terms as it prioritizes the most profitable deals to pursue.

The better the deals they attract, the more they can charge their LP investors.

Time Element of Returns

In calculating returns the timing of the return is a key factor.

There are 2 metrics for measuring return.

1. ROI is return on investment without respect to time
2. IRR which is Internal Rate of Return is ROI WITH respect to time.

For example:

If you invest $50K and receive $150K back in 3 years then your ROI is 3X.

If you receive it back in 5 years the ROI is still 3X.

For IRR the timing makes a difference on the calculated result.

For example:

If you invest $50K and receive $150K back in 3 years then your IRR is 44%.

If you receive it back in 5 years the ROI is 25%.

The sooner the return comes back the higher the IRR.

This is why most angels and VCs quote IRR on their investment results rather than ROI.

Angels and VCs typically look for a 20-30% IRR on their investments.

How VCs Raise and Make Money

Raising Money

VCs raise funding from limited partners which includes:

- family offices
- high networth individuals
- foundations
- pension funds
- other sources

Institutional investors, such as pension funds, require a track record. This means first time VCs focus on family offices and high networth individuals.

In most cases, institutional investors do not like to be more than a certain percent of any one fund due to concentration limits. Typically this is no more than 20%.

The VC develops an investment thesis which is a reasoning why their approach to selecting and funding deals will be successful.

VCs build out their investment prospectus which includes the investment thesis, why it's unique, the fees the limited partners will pay, and how the profits will be distributed.

The VC then meets with limited partners to pitch the investment thesis, track record, and view of the market.

Limited partners look to fund VCs who have a unique investment thesis and access to deal flow they do not.

Making Money

VCs charge the limited partners a management fee on the funds raised. This is traditionally 2% which is paid out every year for the life of the fund.

Some funds stop the management fee around year 6 or 7 as proceeds from the investments start coming in.

MicroVCs often charge 2.5 or 3% of the funds raised since the amount of funds is lower than standard.

The second source is called **carry** and is a percent of any proceeds going back to the investor from the investments.

This is traditionally 20%.

Some funds start taking carry at the beginning of the investment returns while other funds start this after the investor receives their initial investment.

PART II: Raising a Venture Capital Fund

Analyzing a Company to Invest In

Fund managers must present their investment ideas to the other general partners.

Here's how to analyze a potential company for investment:

1. Identify a recent event for the target company such as entering a new market.

2. Discuss how the company can disrupt the newly entered market with their expertise and business model.

3. Talk about the positives you see in the company's financials and market position.

4. Express caution based on any concerns about the business including product/market fit, management team, or cost structures.

5. Discuss macroeconomic issues both positive and negative.

6. Conclude with a recommendation to pursue an investment based on the positives outweighing the negatives.

Sizing and Analyzing the Market

Sizing the Market

One of the most important selling points for a startup is their potential market size.

There are several ways to find the market size for your startup.

1. Buy a market research report.

These typically run anywhere from $5K to $20K. Keep in mind, these are costly and there are other ways to find the market size.

You can typically find the summary of the market research report on the web which usually gives the market size at a high level.

2. You can also contact the trade association related to your industry.

These associations are most often located in Washington DC as they provide government advocacy in addition to industry support.

The website of the association typically provides stats on the industry including market size and sector breakdowns.

These sources are often more reliable than market research reports.

Analyzing the Market

In running a fund it’s important to analyze market segments.

1. Evaluate the leading companies in the market.

Are there any leaders that stand out or are all the companies competing head to head with the same approach?

Highlight the supply chain to show who has control of the market.

Is it the producer or the consumer that drives the price?

Discuss the introduction of new technology and its impact on the current market equilibrium. Will it shift control from the producer to the consumer or vice versa?

2. Review the number of companies playing in the segment and discuss the resulting fragmentation.

Highlight the total available market for the companies in the segment.

3. Identify companies within the market that stand out for competitive advantages such as network effects, virality, recurring revenue models, etc.
4. Conclude with a proposal to pursue investment in a company in the market segment.

Starting Your Own VC Fund and Your Investment Thesis

Your Own Fund

Venture capital, angel investing, crowdfunding, and most forms of startup funding are best done through a fund model for when deal flow volume reaches scale.

A fund structure also provides diversification.

If you have experience finding and screening startups for funding and a track record for successfully investing then you may want to consider starting your own fund.

Currently, there are over 4000 microVC funds in the US alone.

These are funds with around $100M of raised capital with most in the $25M to $50M range.

Many of these funds are led by:

- Those who ran sidecar angel funds
- Invested their own money into startups and did well
- Experienced VCs who set out to run their own fund

The funds tend to focus on a very tight niche in which they have access to quality dealflow.

Most raise funding from family offices as institutions require long track records and large fund sizes so their investment doesn't take more than 20% of the round.

With the above in mind, you can now take your expertise and run your own fund.

Your Investment Thesis

For those raising a fund, you must develop an investment thesis for your fund or investing strategy.

An investment thesis is a hypothesis that describes how a particular market is suitable for producing a positive return.

Most funds are formed around a specific vertical in which the general partners have expertise and access to dealflow.

More than one vertical will require the partners to have expertise across several sectors and the associated dealflow access.

You must be able to articulate your thesis and demonstrate your expertise to investors.

1. Use numbers to describe market sizes and growth rates.
2. Identify trends and their impact on markets and businesses.
3. Show how your investment thesis takes advantage of these trends and how you envision the future.

Targeting Investors for Your Fund

Targeting investors for your fund and getting buy in is a key step in raising a fund.

Potential investors include:

1. Family offices
2. High net worth individuals (HNI)
3. Angel investors

Larger, institutional investors, such as pension funds are typically not interested in unproven fund managers and rarely go below $50M funds.

Institutional investors look for a prior track record and have minimum investments that would put their investment above a limit on how much of the fund their investment takes.

This limit is typically around 20%.

Instead, you could engage a placement agent whose fee is usually in the range of 2-3%.

You can also use meetings with investors before the fundraise to see how the market will respond.

The key to launching the fund is to secure an anchor investor who will allow you to use their name.

You want to do this because it gives the fundraise momentum as the initial funds are secured.

Keep in mind, the most common question will be about past performance. You will be asked if you have led funds in the past and have a track record. Additionally, if you invested as an angel investor in numerous startups then this could count as a performance record. Be sure to highlight any investments that resulted in a successful exit.

If you were an operator of a company with a successful track record, then consider using this for performance as well.

Engage in Brand Marketing

In the past, venture capitalists stood in the shadows of their successful portfolio companies hinting about their contribution using veiled wording in Twitter posts.

Today we see VCs stepping up to take more credit for their contribution. In fact, There are numerous examples of VCs using successful exits as validation for their investment thesis.

With the explosion of venture capital providers comes the need for VCs to engage in brand marketing.

Why?

A list of successful portfolio companies burnishes their brand and helps them gain new deal flow as well as limited partner investors.

Just having a fund is no longer a source of attraction for the best deals because there are too many other funds out there. Today VCs have to position themselves as unique in expertise, dealflow, support, and connections.

VCs need to gain market exposure on their unique value proposition to generate deal flow which is the lifeblood of the VC business model. They are now brand managers who, in many cases, have a business development and marketing team driving the awareness around their fund.

Executive Summary for a Fund

In raising a fund you'll need an executive summary which should include the following:

1. **Fund Objective**

This is the purpose of the fund and how it will be deployed.

2. **Legal Structure**

You'll need to state if it is a fund, syndicate, pledge fund or some other structure.

3. **Fund Specifics**

Most funds are based on a 10 year window.

4. **Distribution Strategy**

Most funds provide a recycle provision that let's GPs reinvest profits back into the fund. Other funds require a hurdle rate before GPs can share in the profits. This means the investors get their principal investment back before the GP takes any carry.

5. **Limited Partner Units**

Private funds are limited to a maximum of 99 accredited investors in the fund.

6. **Fee Structure**

Most funds use the two percent management fee and a twenty percent carry.

7. **Compensation Structure**

This determines when and how the GPs receive their compensation.

8. **Initial Deposit**

Funds vary in how much of the funds are required from investors up front.

9. **Investment Strategy**

This outlines the investment thesis.

10. **Management Team**

This should include the resumes of the general partners.

Fund Reports to the LP

The fund manager provides a quarterly report to the Limited Partners.

The reports typically contain the following sections:

1. **Fund Manager Commentary**

The fund manager provides an overview of the current news and trends related to the fund.

2. **Performance**

This includes the financial performance metrics such as total committed capital, capital called to date, total LP contributions, and summary information about the portfolio.

3. **Total Value to Paid-in Capital**

The total market value of all the companies in the portfolio plus total LP distributions, divided by the total amount of money paid into the fund.

4. **Internal Rate of Return**

A discount rate that makes the net present value (NPV) of all cash flows from a particular project equal to zero.

5. **Distributions to Paid-in Capital**

A ratio of the total market value remaining in a fund compared to total paid-in capital.

6. **Portfolio Company Updates**

Name and description of the company, percent owned, date of initial investment, exit date, total capital invested, current cost, realized proceeds, and carrying value.

7. **Financial Statements**

This may include an income statement, balance sheet and cash flow statement.

Key Metrics and Legal Documents

Metrics

There are 3 key metrics for tracking the performance of a Fund.

These metrics are:

1. **Net Internal Rate of Return (called Net IRR)**

Net IRR measures the performance of fund distributions and the change in value of the invested companies over time after management fees.

2. **Total Value to Paid in Capital (called TVPI)**

TVPI measures the total value of a fund's holdings plus distributions as compared to total paid in capital. This takes into account investments that have increased in value but have not been paid out.

3. **Distributions to Paid in Capital (called DPI)**

DPI measures total distributions paid to investors compared to total paid in capital. This compares the investors paid in capital to their distributions as measured on a cash on cash basis.

DPI is the metric investors care about the most.

Legal Documents

There are 3 important legal documents for your fund.

They are:

1. **Subscription Agreement**

This describes how the limited partners purchase interest in a fund or subscribe to it. It contains representations and warranties.

2. **Private Placement Memorandum**

A Private Placement Memorandum provides a high-level overview of what an investor needs to know about your fund.

3. **Limited Partner Agreement**

This contains information about the mechanics of your fund and how it operates including distributions, capital calls, and management fees.

Returns and Expectations

Returns

The returns on a fund are based on the power law.

This means that the Pareto Principle applies:

The bulk of returns come from just a few of the companies.

Out of 10 investments, 1 will be a home run.

2 to 3 will be small returns.

The rest will be losses.

Expectations

Investors in the startup space have a certain expectation for returns.

Startups raising funding should keep in mind these expectations and only approach them if you have a deal that is in the game for it.

Venture investors including angels, venture capitalists, and limited partners, typically look for a 20-30% internal rate of return (IRR) over a 5-year time horizon.

This can also be expressed as 2 ½-4X the original money invested.

If it takes longer than 5 years then investors will look for a 5-10X ROI to maintain a 20-30% IRR.

About TEN Capital

TEN Capital Network provides funding as a service to companies anywhere raising venture capital. Its network of over 11000 accredited investors represents venture capital, angels, family offices, and high networth individuals.

www.tencapital.group

info@tencapital.group