

TUCK SCHOOL OF BUSINESS AT DARTMOUTH



CENTER FOR  
PRIVATE EQUITY  
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Updated August 12, 2003

## Note on Venture Capital Portfolio Management

**Portfolio management** describes the process investors use to analyze information, make decisions and commit resources to improve or protect the value of their investments.

Portfolio management has four components: (i) portfolio monitoring, (ii) company analysis, (iii) venture capital decision making, and (iv) portfolio company assistance. These processes begin with the closing of the initial investment and are repeated continuously until the closing of the exit transaction. A firm's ability to assist its portfolio companies, also known as adding-value, is what differentiates leading firms from the rest of the industry.

This note is organized into two parts: (Part I) explains typical processes Venture Capitalists ("VCs") use to manage their portfolios; and (Part II) explains how the process of portfolio management is changing in response to challenging market conditions.

### Part I: Overview of Portfolio Management

#### Portfolio Monitoring

##### Information Gathering

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*This case was prepared by Andy Waldeck T'04 under the supervision of Adjunct Assistant Professor Fred Wainwright and Professor Colin Blaydon of the Tuck School of Business at Dartmouth College. It was written as a basis for class discussion and not to illustrate effective or ineffective management practices.*

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Information gathering is an essential component to portfolio management. Firms gather as much information as possible about the performance of each of their companies through a number of different channels including:

**Board Representation.** When Venture firms invest in a private company, most receive one and sometimes two seats on the company's Board of Directors. Board members have a fiduciary responsibility to ensure that the Company is being managed in the best interests of all of its shareholders. Board members receive regular updates on how the business is performing and the key strategic issues that it faces. Members are expected to attend regular board meetings, which can occur monthly, for early stage companies or quarterly, for later staged companies. Prior to each board meeting, each member receives a detailed board package, which is a collection of materials intended to be an all-inclusive update and review of the business. In addition to current financials, board packages typically will contain a written update on progress in the business as well as a detailed explanation of the key issues being discussed at that particular board meeting (such as compensation plans, hiring of key managers, etc.).

**Investor Information Provisions.** VCs and all other investors have information rights which are detailed in the shareholders rights agreement, which is agreed to prior to the closing of a financing. Through these information provisions, investors typically are entitled to receive interim financial statements (which can be either monthly or quarterly), annual budgets or forecasts and completed audited financial statements. Many VCs will request additional information to be included along with these interim financial statements, which help track the Company's progress in achieving certain agreed-to milestones (such as number of customers or number of employees, etc.). In an effort to keep all investors better informed, private companies are now also including written business summaries with interim financial statements. These updates would cover any important business developments, such as additions to the management team or major new customer wins.

**Additional Informal Communication.** VCs will regularly call, email and visit many of their respective CEOs and other senior managers. Some VCs expect to communicate with 80% - 90% of their portfolio companies at least once a week. Investors use these opportunities to ask additional questions or to receive additional management insights. In addition, these situations also present management with a chance to ask questions, seek guidance and get feedback from investors as well. Many investors believe casual and informal communication with management often times provides the most meaningful insights into business or management performance.

### Information Sharing

In most firms, General Partners (“GPs”) and their respective deal teams are responsible for monitoring all investments they have made. Therefore, it is essential for each GP to update the entire firm on the progress of each of his/her portfolio companies. Firms attempt to keep everyone updated through a combination of weekly meetings and less frequent off-sight sessions.

**Weekly Partner Meetings.** Many firms hold weekly meetings (usually on Monday) where each partner will discuss certain of his/her investments. On rare occasions, some firms may choose to discuss the entire portfolio, however usually companies will only be discussed if there are financing transactions, exit transactions or major changes to either the management team or business conditions. These meetings help to serve two important points: (i) to update GPs on where value may be enhanced or lost throughout the portfolio, and (ii) to seek assistance in making difficult decisions with respect to any one particular investment.

**Off-Sites/Portfolio Reviews.** Typically, either quarterly, semi-annually or annually, most firms will perform an exhaustive review of every Company within the portfolio. Some firms ask management to present, while other firms rely upon the deal “champion” to update all of the other GPs. These sessions are designed to thoroughly analyze each company’s performance and assess its current value and prospects. Based upon an assessment of performance and future prospects, a firm may decide to change the portfolio company’s strategy, replace or add members of management and in some cases look for a strategic partner. Firms also use these sessions to assess the overall risk of their portfolio and determine if any changes need to be made to their future allocations. For example, a firm may determine that one stage or sector is looking more promising than others and therefore will encourage additional investment there. On the other hand, firms may assess the relative risk in their portfolio and determine to limit investing activities in certain segments, such as the case with telecom in 2001, 2002 and thus far in 2003.

**Company Analysis**

Importance of Focus and Stage

In general, the information firms choose to focus on is largely determined by the stage and sector of each company. For example, for a pre-revenue biotech investment, a VC will want to track expenses and be updated on the status of the regulatory approval process. An investor in that same company at a later stage may track the sales pipeline (ie. future revenue), expenses and progress on future R&D efforts.

Listed below are examples of the type of information that VCs would focus on depending upon stage.

	<b>Early Stage (Pre Revenue)</b>	<b>Early Revenue</b>	<b>Close to Profitable/Profitable</b>
<b>Financial Metrics</b>	<ul style="list-style-type: none"> <li>• Operating expenses</li> <li>• Cash burn</li> </ul>	<ul style="list-style-type: none"> <li>• Operating expenses</li> <li>• Cash burn</li> <li>• Revenue</li> </ul>	<ul style="list-style-type: none"> <li>• Revenue</li> <li>• Gross margin</li> <li>• Operating expenses</li> <li>• Cash</li> </ul>
<b>Business Milestones</b>	<ul style="list-style-type: none"> <li>• Product development</li> <li>• Additions to the team</li> </ul>	<ul style="list-style-type: none"> <li>• Product development</li> <li>• Customer input on product features</li> <li>• Team</li> <li>• Sales pipeline</li> </ul>	<ul style="list-style-type: none"> <li>• Sales pipeline</li> <li>• Bookings</li> <li>• Team</li> <li>• Marketing plan</li> </ul>

VCs Use Many Approaches

While many firms look at similar data for their portfolio companies, there exists great variability in terms of what investors actually focus on when analyzing performance. Discussed below are two different approaches VCs use to manage their investments.

**Focus on Cash.** One venture investor looks at many different factors to help determine the ultimate impact on cash flow. “I monitor cash. For my companies that are making cash, I monitor how much cash they are making and how quickly they can make more. For those companies that are losing cash, I monitor how fast

they are losing it and when they expect to stop losing cash.” He considers every decision with respect to the ultimate impact it will have on cash. “I may be very interested personally in how one of my portfolio companies is going to change their website. However, since changing a web-site doesn’t impact cash to a great extent, I don’t spend any time on it. For anything that has a significant effect on cash, I spend a great deal of time on.”

**Focus on Vectors.** Another venture investor has a different approach. “When looking at the financials of a portfolio company, rather than focus on a particular set of numbers, I focus more on vectors. Generally, the overall trend needs to be up and to the right, but you have to expect some dips along the way.” This does not imply that financial results are ignored, but rather that variances should be expected in early stage companies. “Irrespective of whether or not a company makes its numbers, I will spend a great deal of time talking with management to understand what is happening. If the company missed its plan, I want to understand what went wrong. Depending upon why they missed, I may decide that changes are needed. At the same time, however, if a company blows away its plan, I want to know why the budget was so far off. Either case may signal to me that a management issue exists.”

#### Early Stage Financials Require Interpretation

The goal of investment monitoring is to provide as much relevant information to assist VCs in making potentially difficult decisions. These decisions are complicated by the fact that venture investments are typically early stage and therefore the business lacks repeatability and there is less historical information on which to rely. In addition to lacking consistency, changing external factors can have a potentially dramatic impact on these young businesses as well. For example, when the dot-com bubble burst, many potential customers became wary of buying products and services from any startups (whether warranted or not). Should such a “sales issue” be interpreted as a problem with the company’s sales team or an external condition affecting the business? As a result, should the VC do nothing or recommend a change in management?

Unlike later-staged, more predictable companies, a variance from a monthly budget may or may not be indicative of an unhealthy situation. For example, a company may have budgeted \$100k for a particular expense, yet in that period may have spent \$125K, a 25% increase over budget. One interpretation would lead an investor to question management’s ability to control costs, yet another may commend management for spending more in support of higher growth. In some cases, traditional financial analysis is important, yet it may not clearly signal the most appropriate response for investors.

### Venture Capital Decision Making

Given the complexities of venture financial statement analysis, determining when a “trend” indicates a “problem requiring action” can be quite complicated. As a result, VCs rely upon a combination of past experience and “pattern matching” to determine how to best to interpret and respond to different situations.

**Past Experience.** In analyzing any one particular company, VCs rely heavily upon prior experience (personal as well as within the firm). One venture investor characterized monitoring portfolio companies in a similar fashion to looking at art. “You look at a lot of art, some is good, some is ok and some is bad. At some point, after seeing enough art, something inside clicks and you start to appreciate why certain art is good and more importantly why certain art is bad”.

**Pattern Matching.** In addition to relying upon past experience and “sense”, venture investors rely heavily upon pattern matching. Pattern matching has been described by one VC as “putting the different tiles together to see the whole picture.” Examples of different “tiles” VCs would consider in forming an opinion would include:

- Activity within the portfolio can help an investor better understand whether or not an issue facing one company is affecting other ones of a similar stage or sector.
- Performance of comparable companies outside of the portfolio can also be an indicator of whether or not a particular issue is unique to the company or affecting an entire segment.
- Past performance may also provide helpful insight. Many VCs believe firms exhibit fairly consistent growth patterns due to common limitations (such as transitioning from early adopter to mainstream customers). Some businesses are able to overcome these issues earlier in their lifecycle because they have a unique set of resources and capabilities. Knowledge of past performance in a sector serves as a reference VCs can use to challenge growth assumptions when presented with a plan or new strategy.
- Transition periods observed in other companies can be used to alert VCs as to periods where changes in management may be required. All businesses go through natural transitions – from R&D focused to sales and marketing focused. VCs know this period can be a natural transition

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point for some managers as well. Monitoring how managers respond to these situations helps to indicate whether or not a change is needed.

- Current news often helps to signal to VCs developing and emerging trends that may affect business performance.

### **Portfolio Company Assistance - “Value-Add”**

#### Common Areas of Assistance

VCs have two very powerful mechanisms to affect change in a portfolio company. VCs can replace management (with board approval) or decide to sell the company (by either voting at the board level or simply refusing to invest additional capital). Both of these measures, while effective, are quite drastic. There are a number of other ways that VCs lend their expertise to help their portfolio companies achieve success. Generally all VC firms will provide the following assistance to portfolio companies:

**Financing or Exit Transactions.** VC firms by nature have unique insight into the current trends in the private equity markets. In addition to providing market insight, VC firms will often make introductions for portfolio companies to other VC firms when looking for a lead investor for another round of financing. Most venture firms also have relationships with commercial banks which can be used when portfolio companies require debt financing. Finally, venture firms also have strong relationships with leading investment banks and are highly active in the selection of the banking syndicate and throughout the IPO process.

**Strategic Advice.** All firms can utilize their extensive experience as investors in, and in some cases operators of, similar businesses to provide strategic advice to growing companies.

**Teambuilding/Recruiting.** Most firms take a very active role in helping to recruit and build out the senior management team. Many firms focus a great deal of their energy on evaluating management teams and making additions or changes where appropriate – including recruiting and interviewing prospective new hires. Some firms, such as Bessemer, have even expanded to include formal executive search and recruitment departments, focused solely on placing world-class talent into its portfolio companies.

**Leveraging Contacts.** All VCs have extensive contacts within their respective industry segments. VCs leverage these contacts for a number of purposes, including negotiating transactions on behalf of portfolio companies or sourcing exit

transactions. Portfolio companies can also leverage these contacts directly to assist in new business development, sales support and gathering market intelligence. In addition, leveraging contacts also includes resource sharing within the portfolio. Accell Partners, Battery Ventures, Crosspoint Venture Partners and many others as well actively encourage interaction amongst portfolio company management teams.

**Crisis Management.** Startups from time to time may experience times of crisis – such as the loss of a major customer or senior member of management, a cash crunch or a major design or development issue. During these times, VCs will utilize any and all available resources, in some cases acting as interim management, in order to protect and save their investment.

#### Segmentation Based Upon Operating Focus

While all firms provide assistance to their portfolio companies, a major distinction amongst firms can be made. Venture capital firms can be segmented based upon the type and level of support they provide to their portfolio companies. Some firms choose to be extremely active in the day-to-day operations of their portfolio companies, while other firms choose to focus their attention on higher-level strategic issues.

Firms such as Boston Millennia Ventures, Ascent Venture Capital and Summit Partners (Accelerator Fund) view their value-add to portfolio companies as a strategic advisor. These funds focus heavily on selecting the right management team and then rely upon the team to operate the business effectively and efficiently. From time to time, these funds will become involved in operating issues, such as managing cash burn. These firms rarely proactively seek out such opportunities and instead respond to problems as they arise.

In contrast, firms such as Advanced Technology Ventures, Mobius Venture Capital and Crosspoint Venture Capital tend to be more heavily involved in the tactical operations of their portfolio companies. These firms also view their value-add to portfolio companies as a strategic advisor, however, when appropriate, these firms will also provide additional operating advice or tools to help their portfolio companies. These firms may assist in any area of a portfolio company's operations including sales (strategy, support, development), marketing, partnerships, international expansion and many others.

For example, Mobius Venture Capital recently launched a new initiative called the "Intellectual Capital Project." The goal of this project is to provide each portfolio company with best practices to help them run more effectively and efficiently. The project provides a combination of "tools," "documentation" and "resources" that

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venture CEOs can utilize to prevent them from wasting time re-inventing the wheel. Current topics include:

- *Tools:* Sales pipeline, sales compensation, cap table, option plan, and paid time off worksheets;
- *Documentation:* Collections best practices, product positioning and product strategy tactics and current trends in incentive compensation plans; and
- *Resources:* List of local networking events for entrepreneurs, recommended vendors, links to other educational resources.

#### Segmentation Becoming Less Prominent

Recently, however, the line segmenting firms by “operating focus” has blurred. Firms with traditionally strong finance and strategic skills have added new GPs with strong operating experience and firms with strong operating experience have added new GPs with strong finance and strategy skills. In addition to hiring GPs with different backgrounds, some firms have experimented with an entirely new position - Venture Partner (“VPs”). Typically these individuals have deep operating experience and can work with companies within the portfolio to help realize value as well as contribute in the deal screening and evaluating process. In some cases these VPs may in fact step in and run the business on a part-time basis or may be used to start entirely new business on behalf of the VC firm. Compensation and role within the firm vary quite significantly from one firm to the next, with some Venture Partners only working on a part-time basis.

#### Value-Add Differentiates Leading Firms

“Value-added” is the final step of the portfolio management process. Given that portfolio Companies are looking to maximize the return from their investors, value-add often times serves as the deciding factor when choosing an investor. As a result, time and time again, leading firms have been able to negotiate more favorable deal structures than other firms can negotiate based largely upon their reputation and strength of their value-add.

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## Part II: The Changing Nature of Portfolio Management

### Challenging Times for Venture Capitalists

As a result of declining overall economic conditions, VCs are feeling significant pressure from each of their different constituencies. GPs within firms are looking for earlier indications of potential risks within a portfolio. Limited Partners (“LPs”), looking for increased transparency of information, are looking for more frequent company updates with more meaningful information. Moreover, some LPs are questioning what value-add GPs provide in addition to simply a public/private market arbitrage. Finally, portfolio companies themselves are requiring more assistance in these challenging economic conditions. As a result, many venture investors are spending greater time and effort in managing their portfolios – to support and build companies that can return real value while also limiting the downside from continued underperformers.

#### Pace of new investments are at the lowest levels in 5 years

Venture capital investment in the first quarter of 2003, fell 41% to \$3.40 billion from \$5.73 billion in the first quarter of 2002 and 21% from \$4.32 billion in the fourth quarter of 2002, according to the Ernst & Young/VentureOne Venture Capital Survey. Quarterly venture investment fell below \$4 billion for the first time in five years. According to the report, “deal flow is on par with 1996, and dollars invested are in the 1997 range.”

#### Current M&A activity is at levels not seen Since 1996

The Venture Economics and the National Venture Capital Association reported that 65 venture-backed companies were acquired through merger or acquisition for a total disclosed value of \$1.34 billion in the first quarter of 2003. These results represent a decline from the fourth quarter of 2002, when 83 companies attracted \$1.62 billion. The decline in the first quarter represented the lowest dollar total since the first quarter of 1996, when 27 companies were acquired for \$1.23 billion.

#### Returns continue to decline – particularly in early stage/newer funds

Driven by lower valuations and lack of exits, one-year returns for venture capital funds stood at negative 23.3% as of Dec. 31, 2002 compared with negative 27.4% in 2001, according to the latest survey by Thomson Venture Economics and the National Venture Capital Association. The internal rates of return for the average 10-year lifespan of funds continued to worsen. The three-year IRR for VCs plummeted from 51.1% in 2001 to negative 6.8% in 2002, while five-year and 10-year returns slipped from 36.9% and 26.9% in 2001 to 28.3% and 26.3% in 2002, respectively.

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The hardest hit were early-stage venture funds, which posted a negative 27.6% one-year IRR, compared with negative 33.6% in 2001. However, in the long term, the investment class has done well for investors. It is showing a 34.9% 10-year IRR, the highest for the entire industry.

In an analysis of recent vintage funds' performances, the survey said the younger funds face a tough challenge, compared with 1996 vintage funds. For instance, vintage 1996 funds had returned 1.11 times the original investment to investors, while remaining portfolios had a combined valuation of 3.85 times the cost. In marked contrast, vintage year 1998 funds have returned only 57 cents on the original investment dollar, and the remaining portfolios are valued at 94 cents to the dollar at the three-year mark. Vintage 1999 funds have returned only 20 cents on the dollar, and remaining portfolios are valued at 43 cents on the dollar at the three-year mark.

#### Increased Regulations Impacting Corporate Governance

The Sarbanes-Oxley Act of 2002 was designed to protect investors in public companies. However, this recent legislation has wide reaching implications for a number of key players, which will ultimately impact private companies and their investors. The major provisions and implications of the Act are:

#### **Establishes an Independent Auditing Oversight Board (“PCAOB”) Under the SEC**

- All public accounting firms will have to be registered with the PCAOB
- PCAOB will publish auditing standards to be used by firms when issuing audit reports
- PCAOB will monitor compliance amongst registered firms

#### **Redefines Auditor Independence**

- Firms may not provide bookkeeping, IT consulting, valuation, actuarial, outsourcing, H/R, or other management services to audit clients
- Auditors must be approved by and disclose all material documents to the audit committee

#### **Defines Corporate Responsibility**

- CEO and CFO must certify validity of quarterly and annual financial statements
- CEO and CFO must repay any bonus or incentive based compensation received for a period of 12 months after the release of any financial statements which are later restated due to material noncompliance by the issuer

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- Attorneys are required to report any material violation of securities law or breach of fiduciary responsibility
  - Establishes fund to benefit aggrieved shareholders

**Enhances and Accelerates Financial Disclosure**

- Off balance sheet transaction must be explained in MD&A
- Companies can no longer extend credit to any director or executive officer of the company
- Directors, officers and 10% shareholders must report stock transactions within two days of transaction occurring (in the past these transactions had to be reported within a period of ten days)
- Companies shall disclose on a “rapid and current basis” material information

**Eliminates Analyst Conflict of Interest**

- Analysts can no longer be compensated for investment banking transactions
- Analysts must certify that opinions expressed in their reports accurately reflect their personal views

**Increases Penalties for Corporate Wrongdoers**

- Penalties for white collar crimes and falsification or destruction of documents have been significantly increased

**VCs Response to the Environment**Increasing Intensity and Effort

One VC characterized the current situation as the following: “We are spending more time evaluating our portfolio because we must be sure the original value proposition still holds for each particular investment. In a more robust economic environment, a particular company’s value proposition is challenged everyday in the market. As a result, a VC can easily see whether or not a portfolio company has a sustainable value proposition by its success with customers. However, in an environment where customers are few and far between, VCs have to dig deeper to better understand and question a firm’s value proposition. Essentially we are performing the same level of due diligence on portfolio companies as we would with any new investment. In normal markets, any particular company would require additional financing every twelve to fifteen months, and would be put through a formal due diligence process. In this market the half-life has shrunk, and we must do all the work ourselves.”

Below are examples of two specific firms that have changed their portfolio management practices to provide, better and more timely information.

**Mobius Venture Capital.** One GP requires all of his investments to report weekly metrics, in addition to providing monthly financial statements. These weekly reports include: revenue, gross margin, EBITDA, net income, cash, 1<sup>st</sup> month of profitability, cash need to get to profitability, debt and many other key metrics. Each deal team then produces written updates on their portfolio companies which are distributed to the entire firm. Based upon these updates, Mobius reviews the carrying value of all its investments at monthly meetings with its Advisory Board.

**Norwest Venture Partners.** Each Monday meeting is used to discuss only the companies within the portfolio which are not meeting plan – a process which takes approximately half the day to work through. For the second half of the day, Norwest has the management teams from the companies previously discussed, present in person to all of the GPs. Based upon these meetings, Norwest will make a determination regarding both the company's and management's ability to be successful. The outcomes of these meetings may result in altering the business' strategy, recommending changes in management or making the determination the company must be sold.

#### Pushing For Earlier Decision Making

VCs have spent a significant portion of the last three years, “culling” their portfolios - essentially deciding which companies within their portfolios must be shut down and which ones they will continue to fund. Looking back, many firms believe that when they made decisions, such as that a change in management was needed, it was usually too late. In some cases, necessary changes never happened because of infighting from other board members and investors. As a result of this experience, VCs are seeking to make faster, more decisive decisions.

For example, Norwest Venture Partners, has attempted to solve this problem by managing companies based upon a Zero Cash Date (“ZCD”). When a portfolio company is nine months from its ZCD date, the partners make a formal decision at that time whether or not to continue funding the company or whether or not the company should be sold.

#### Moving Towards Standardization

In an effort to reduce the time required to monitor each investment as well as add a degree of structure to the process, some firms such as NEA have responded by completely standardizing the information they review for each portfolio company. Such “dashboards” provide the same data for all companies regardless of stage or

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sector. A typical dashboard would include a combination of both financial and business items. Dashboards are designed to provide VCs with a consistent view across their entire portfolios. Advantages of using dashboards:

**Improves Leverage.** With dashboards, GPs do not have to spend a great deal of time searching for pertinent data on a portfolio company. By reducing processing time, dashboards help create additional leverage for GPs, allowing them to spend more time looking for new deals or fundraising.

**Good for LPs.** Dashboards can be easily modified and sent to LPs as a way to provide more timely information. Such a common format eliminates the work of taking numerous different formats and standardizing them when reporting fund performance to LPs.

**Establishes Common Goals.** Large firms with many GPs (each with different compensation structures and objectives) and multiple funds have found it increasingly difficult to track both portfolio company and GP performance. Dashboards help to improve the monitoring and oversight functions for these firms by establishing common metrics that all companies and GPs can be monitored against.

While most firms are making concerted efforts to add more structure to the portfolio monitoring process, dashboards aren't appropriate for all firms. Arguments against using dashboards:

**Unnecessary for Younger and/or Smaller Firms.** The principal adopters of dashboards have been firms like NEA, who have raised megafunds and are trying to improve the leverage of each GP. However, for smaller firms with less capital under management such structure simply isn't necessary.

**Other Investor Requirements.** Few VCs are sole investors in any companies these days, therefore format will have to comply with wishes of other investors. Each firm has different information requests. Any presentation will have to incorporate some level of input from multiple firms so unless all the firms have the same standard dashboards, the firms will have to modify their reports.

**Businesses Are Unique.** Many firms prefer to view a business based upon its unique characteristics and the ways that management "looks at its business." These firms prefer reports that are consolidations of the management reports used by each business head. Many firms use the quality of financial reporting (ie. seeing what management believes is important) as one way to evaluate management's abilities.

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In addition, many firms track performance based upon specific milestones that are unique to each investment.

**Doesn't Apply to Pre-Revenue.** For pre-revenue firms, monitoring the “speed” or the progress towards customers and revenue is quite unique and therefore cannot be “normalized” across an entire group.

**Requires More Work for Portfolio Company.** Requiring a particular presentation may result in businesses keeping two sets of financials and thereby not only increases the amount of work for the portfolio company but also the likelihood that translation mistakes occur.

#### Increasing Emphasis On Corporate Governance

Many VCs, some in response to increased pressure from LPs, have made an active effort to reduce the number of boards in which they participate. These investors recognize that limits exist to the number of boards any one individual can actually manage. Many firms now are requiring that GPs participate on no more than eight to ten boards at any one time.

Given the slow IPO market, the eventual effect of Sarbanes Oxley has yet to be felt by private companies attempting to go public. However, in the M&A market, certain implications are already becoming apparent. Some public companies are already requiring management and investors make representations and warranties about their compliance with Sarbanes Oxley. In addition, other changes are beginning to take place particularly between companies and their auditors. As specified in Sarbanes Oxley, auditors are reporting all material information and documentation to the audit committee. In addition, members of the audit committee are increasingly challenging the assumptions underlying financial information presented to them by management.

As a result of Sarbanes Oxley and an increased emphasis on corporate governance in general, venture investors are increasingly concerned about “lookback periods.” VCs understand they will be major shareholders at the point of an IPO and therefore are liable for any improprieties that may have occurred for a period of time prior to the company’s going public. As a result, many VCs are pushing their portfolio companies to grow up (from a governance standpoint) much earlier than they had previously done.

#### Emphasizing Board and Investor Due Diligence When Considering New Investments

Firms are increasingly focusing on who the other board members and investors will be in any potential new investments. Over the last few years, many firms

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experienced significant losses in certain investments as a result of disagreements within boards and/or company investors. In certain cases, decisions that should have been made such as changes in management or the sale of a company) were never approved. Some firms completely exited certain segments, such as telecom, and determined not to continue funding any investments in those spaces. Other investors felt “burned” by such decisions, having made their investment decisions expecting existing investors would participate in future rounds. Often times portfolio companies in this situation would have to be sold, or in some cases shut down due to lack of insider support.

As a result, firms are spending more time performing due diligence on other investors (looking at overall fund size and likelihood of reinvesting) or deciding to only invest with “well known firms.” In some cases firms have become more aggressive in negotiating for “optimal” board structures in term sheets – sometimes making a change to the board a requirement to completing a transaction. In situations where these conditions were not met, firms have decided to walk away from investments they would have otherwise made.

## Conclusions

### Current Intensity is Market Driven – and Likely to Decline As Markets Improve

While many firms insist that current portfolio management practices will remain in place going forward, it is to be expected the intensity will “back off” when the markets improve. Considering that the venture capital business requires effective utilization of time, the devotion of significant resources to portfolio management – may result in a firm’s missing out on new investment opportunities. Therefore, just as market conditions change, VCs daily practices change as well. In good markets (like the 1990’s) VCs spent a great deal of their time focused on exit transactions, pursuing new deals and helping to create new companies because there are many opportunities to realize gains. In challenging environment, such as (2001 – 2003) firms are focusing on limiting the potential downside risk for any particular fund. Therefore, portfolio management will be an ever-evolving process that receives greater emphasis in bad markets and less emphasis in good markets.

### Standardization Does Not Work For All Firms.

Despite LP’s frustration with the lack of standardized processes across firms, portfolio management will continue to be a unique process for most venture capital firms. Dashboards and complete standardization may not be appropriate for all firms, yet adding some degree of structure to the process of portfolio management can have significant benefits such as quicker decision making, increased leverage, etc.

Little Impact Yet from Sarbanes Oxley, but Significant Changes Are Still Occurring  
With no exit market to speak of, we have yet to see the full impact of Sarbanes Oxley on companies attempting to go public. In the M&A market, the impact of Sarbanes Oxley is already beginning to be seen. However, there are significant changes occurring at the board level. Like with public companies, the relationship between private companies and auditing firms has changed significantly. Moreover, driven by pressure from both existing investors and investment bankers, firms will have to demonstrate well functioning corporate governance practices well in advance of going public.

Venture Partners Meet Mixed Results

Some firms have found the role of venture partner has created significant value, while other firms have found it more challenging. In some situations Venture Partners have encountered significant resistance from portfolio companies who view them as spies. In addition, the role of Venture Partner may be a current market phenomena – driven by firms seeking to bolster operating experience and entrepreneurs who are waiting for market conditions to improve.

VCs Need to be on Fewer Boards not More

In the height of the bubble, some VCs were on as many as fifteen boards at once, and in some cases even more than that. Venture Investors, and their LPs, have learned that most VCs cannot devote the necessary time and attention to that many companies. As one VC said, “When you are trying to follow that many companies, too many pieces end up falling through the cracks.”

Decisions Will Be Made as Early as Reasonable

Given the losses experienced over the last three years, many firms have recognized the importance of making decisive decisions as soon as practicable. In response, these firms are establishing processes that allow them to make “better” informed decisions earlier in a company’s development.

Firms Will Only Invest with Other Firms/Partners They Know

Almost all VCs agree that as a result of the difficulties experienced in the late 1990s and early 2000s, future deal syndicates will be less likely to combine firms with little collective history. Many expect conditions to mirror the 1980s and early 1990s when firms primarily invested with a limited number of other GPs that they knew well and had positive experiences with in the past.

### References And Selected Reading

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