



TechWatch - Fixing the Venture Capital Model

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For this month's Tech Watch article I have chosen to switch gears and discuss the venture capital side of things. There has been a lot of talk for a while now about fixing the venture capital model. As it stands now, there are things about the model that do not align the wants and needs of VCs with entrepreneurs. For example, VCs need exits at certain time intervals because their funds only last 10 years (for the most part) and entrepreneurs are sometimes forced to grow too quickly or be acquired too soon because of this. While the structure of VC funds probably isn't going to change any time soon (after all, the people that invest in VC funds need their money back to pay pensions and do charitable work) the question is: What can be changed? The answer: deal structure.

The way VC deals are structured is something that, with a little creativity, can make the system much better for both parties. There is a fundamental problem between VCs and entrepreneurs. Both VCs and entrepreneurs want the company to shoot for the stars and to be the next Google (although, most VCs would take a return a fraction of the size of Google). However, if someone comes along and offers an entrepreneur \$25mm for a company built with little of his own money and with minimal sweat equity, the odds are that the entrepreneur is going to take it. However, that \$25mm offer looks paltry to a VC who, let's say, put \$7mm into the deal at a \$22mm post money valuation (especially if the VC invested in the company with the intention of the company being worth \$200mm). The return on investment for the VC does not line up with the return on investment for the entrepreneur.

The Partial Founder Buyout. Partial founder buyout can change this dynamic by giving the entrepreneur a little liquidity early on. Let's say that, in the above scenario, the VC actually put \$10mm into the deal but \$3mm was actually paid in cash to the entrepreneur and \$7mm went into the company. Now, the entrepreneur has \$3mm in the bank. This is not enough to make him too comfortable but it is enough to reduce, if not eliminate, his urge to sell out quickly for \$25mm. Now, the entrepreneur is more likely to take the plunge with the VC and try to become the next Google knowing that his house and his children's college educations are taken care of.

If this type of situation was in practice today I think we would have already seen its effects. Let's take Flickr for example. The founders of Flickr built the company on a shoestring in their spare time. Network effects began taking hold and before they knew it they had an incredible company on their hands. At that point the founders needed to make a decision: do they take capital from a VC and scale the business and risk flaming out or

take the “sure thing” offer on the table from Yahoo! and cash out early possibly leaving money on the table but also taking in enough money to live comfortably forever? In this case the founders took the Yahoo! deal and probably regret it today but can you blame them? They were looking at a lot of guaranteed cash or getting their ownership diluted possibly for no more return (or maybe even less return). (The same situation could be applied to a number of other companies including del.icio.us.)

Jeff Clavier of SoftTech VC chimed in and commented on my initial blog post about this topic a week or so ago. He brought up a good point. Essentially he said that partial founder buyout would not work for the smaller seed type deals where investors are putting in smaller money. This makes sense if you look at the math. The partial founder buyout chunk of the deal would not be big enough to be significant to the entrepreneur. Another reader commented that control issues are another barrier that partial founder buyout would need to climb over. Often when a VCs gains more control of the company they would lose “control” of the entrepreneur. While control of the company is what should be strived for it could be argued that some VCs, not all, want to control the entrepreneurs as well and partial founder buyout would lessen this form of control.

With that said, if partial founder buyout was already in place I believe a lot of entrepreneurs would be still out there building their companies and VCs would be left with more quality investments. Everybody wins except maybe the Yahoos! and Googles of the world since they wouldn't be seeing any more inexpensive acquisitions. Partial founder buyout is not for all deals but if used in specific situations it could be very beneficial. In any case the partial founder buyout is something that should be fleshed out because it could change the start-up game forever.

For more information on this subject please see my blog (VentureWeek.com/blog) and my string of “Fixing the Venture Capital Model” posts. I will also be doing a podcast on the subject in the next couple of weeks with some prominent VCs. Please check out VentureWeek.com for more info.