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The New Faces of Venture Capital

By SC Moatti

Venture Capital is usually thought of as a sub-class of private equity designed to provide financing to emerging companies with high growth potential in exchange for equity and some ownership stake. Initially reserved to rich families, it became a professional industry thank to the Small Business Investment Act of 1958[1] and the ERISA Act of 1974,[2] both of which allowed venture capital fund managers to access sources of capital beyond private wealth.

Today, it has become a thriving industry with ~900 firms managing ~$300bn according to the National Venture Capital Association.[3] Venture Capital is no longer a rich man's game, or a cottage industry, it has become a complex ecosystem. As this shift has taken place, several shrewd venture capitalists (VCs) have set themselves up in distinct segments as a way to differentiate their risk-return profile –a concept once unimaginable in venture capital.

These new VCs are meeting the demand of investment managers in new ways, and generating superior returns. Who are they and what funds are they building? Here are three categories I find particularly compelling: the whale, the dolphin and the minnow.

#1. The Whale: All-In, All-Alone, Swinging for the Fences.

Every few years, a company emerges that will return investors' money 100 times or more, this is what whales are designed to capture. Consider Facebook. The network effect of the platform makes it a quasi-monopoly with tremendous opportunity for growth and monetization. I had the chance to work there in the early days; it was thrilling to be part of a company with such prospects. There was a sense of urgency and excitement everywhere, so much so that employees didn't feel they were working. Instead, they were changing the world. As a VC, it didn't matter how much and at what valuation you invested in, you would make a lot of money and return your fund to your investors no matter what.

Whales are out trying to catch the next Facebook. When they believe they have found it, they go all-in. They don't want or need to syndicate their deal with other VCs, they go all-alone. They aren't valuation-sensitive because they know the returns will be extraordinary, they swing for the fences.

But the returns of whale funds are declining, and asset managers should be prepared for a 1.5-3X cash-on-cash multiple. So they need to carefully pick which whale(s) to invest in. I suggest they consider the following criteria:

- Bigger is better.
- Brand matters.
- Look toward Asia.

#2. The Dolphin: Curator, Syndicated, Mining the Ecosystem.

While the whales are busy looking for the next Facebook, many thriving businesses need venture capital funding, yet they won't turn up like Facebook. Take Penumbra, the medical device manufacturer. It emerged as a market leader in a specific niche that other giants in that industry, such as Medtronic, overlooked. It was able to gain market share profitably by being very capital efficient. It took limited outside capital and carefully selected investors who could add value beyond just the money. Penumbra went public, returning investors money 10-20 times (depending on how early they invested). Since its IPO, its stock has continued to thrive. As a VC, every dollar invested was worth it because it was put to good use and value creation was maximised.

Dolphins are trying to source deals like Penumbra. When they believe they have found one, they syndicate the investment with fellow VCs based on how much value each of them provides on top of the monies. They are valuation sensitive, build a highly curated portfolio of investments, and carefully nurture the ecosystem they belong to, so that they can effectively mine it.

The returns of dolphin funds can be outstanding, and as an investment manager, you should demand a 3-5X cash-on-cash multiple. When evaluating dolphins, I suggest the following selection criteria:

- Defensible differentiation is everything.
- Smaller is better, with co-investment opportunities for limited partners.
- Focus on Silicon Valley.

#3. The Minnow: Rookie, Opportunistic, Spray-and-Pray.

Innovation is everywhere, if you think about it. Sometimes in the most surprising places. Confirm.io for instance, the government ID authentication service, was started in Boston and recently acquired by Facebook. It had received funding from local investor Cava Capital and a few private investors who believed in its mission to make the world safer for everyone. As a VC, this opportunity would be unlikely to land on your desk because it flies under the radar. But if you were lucky to add it to your portfolio, you'd have had an exit thank to the recent focus on fake news appearing in the Facebook Newsfeed.

> *Before you pick which venture capital funds to invest in, make sure you understand what segment they belong to and set your expectations accordingly when it comes to returns.*

Minnows are playing rookie by placing bets on companies they believe could meet a very specific need in the near future. They're looking for arbitrage and quick exits, being very opportunistic in their approach. Sometimes, their bets are good ones, most often they fail. It doesn't really matter because they don't put much money to work anyways. They're in it for the thrill, so they just spray-and-pray.

But the returns of minnow funds are unpredictable, and you should be prepared to write off your investments. So as someone responsible for managing money professionally, your best strategy is to either steer clear of minnows, or allocate a small position in a fund of fund focused on minnows.

Venture Capital can generate huge returns if you understand that it's no longer an asset class with a single allocation profile. Before you pick which venture capital funds to invest in, make sure you understand what segment they belong to and set your expectations accordingly when it comes to returns. While the whales and the minnows can seem alluring, the true upside is with an allocation strategy focused on dolphins.

SC Moatti is a Silicon Valley investor, entrepreneur & visionary. She is the managing partner of Mighty Capital, a Silicon Valley venture capital firm, and Products That Count, one of the largest communities of product managers, leaders and entrepreneurs in the world. Previously, she built products that billions of people use at Facebook, Nokia and Electronic Arts. She also serves on boards of both public and private companies, including mobile technology giant Opera Software (OPERA:Oslo). An award-winning bestselling author, Moatti frequently gives keynotes on investing and innovation at prestigious conferences globally, including the Mobile World Congress, the SuperReturn Conference, and the Commonwealth Club; and has been featured in The Wall Street Journal, the Harvard Business Review, and on NPR. She lectures at Stanford Graduate School of Business, where she earned her MBA and has a Master of Science in electrical engineering. Andrew Chen, one of Uber's top executives, called SC "a genius at making mobile products people love." For more information, visit scmoatti.com

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