A VC's Guide to "Return on Time"

by: Sean Foote, Labrador Ventures – April, 2006

When it comes to the increasing gap in seed stage funding – return on time (aka, ROT) is everything.

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Return on time. It's not just a clever twist on 'return on capital', it's now a trademarked piece of the English lexicon. And as our neighbor and colleague Marty Pichinson, the guy who coined it and trademarked it, puts it: "Time can be the Achilles heal for any VC."

Marty should know. As the co-founder and co-head of Sherwood Partners, a Palo Alto, CA-based restructuring and consulting firm, he's seen his fair share of good deals and bad, and if he has one message for VC's it's that they should concentrate more of their time and efforts on the top 50 percent of their portfolios – and less on the bottom 50 percent. It's a thesis that cuts directly to *return on time* – particularly now that venture funds have grown ever larger, and VCs search for more efficient ways to leverage themselves beyond the traditional 6-plus deals per partner formula we've all grown accustomed to.

Less is More?

VC's are now seeking the right balance between deploying excess capital, and doing so in a way that is responsible for investors and entrepreneurs alike. As funds have grown larger, they've either had to: **a)** convince entrepreneurs to take more money – thus pushing entrepreneurs to sell more and more of their companies; **b)** participate in later stage deals where there's more competition for capital, and thus less upside for valuation expansion, or **c)** watch from the sidelines as some deals – and exits – go to smaller angel groups and early stage funds that then choose quicker exits rather than taking additional venture capital rounds. It's this latter trend where changes maximizing *return on time* can make a great deal of sense for true early stage funds.

Before AOL acquired video search-engine company Truveo for roughly $30 million in January 2005, several venture capital firms tried to invest – to no avail. The VCs couldn't do smaller rounds and the company saw an exit with a major player as the better path towards success. Umberto Moretti, CEO of a six-person software startup for the sales management industry, InsideView, knows this concept all too well. Moretti, a former founder of DigitalThink, has been in the market for seed capital for the past three months but his choices are fragmented. The number of early stage Silicon Valley VCs that can do deals of $500K to $1M can be counted on one hand. And the angels remain a fertile but sometimes scattered market with little follow-on capital readily available.

If Moretti wanted to raise $5 million, he'd likely have choices galore as more VCs are able to spend more *time* on $5M investments than on any amount less than that. Yet, not only might Moretti not want to sell that much of his company, he – like many entrepreneurs – feels that taking smaller amounts of capital is actually good for business. "At the early stage we need to stay tight and focused, we need to be cost conscious, listen to our customers, and understand the size of the market as well as the true market opportunity," says Moretti. "If we have too much money, that won't help us drive to revenue any faster or, in turn, understand how much funding we might need in the future."

Time is Money

In today's VC world it's often not feasible for a partner in a $500 million fund to put $500K to work in a deal – "The value of his time, from our perspective, is the same regardless of whether it's a $500,000 investment or a $5M investment," says Moretti. But from a partner's perspective, the *return on time* given the size of some large funds today simply can't justify the economics of doing deals that small. U. S. VC's attracted $25.2 billion last year, up 46 percent from 2004, and the highest amount raised since 2001, according to *Venture Economics*.

Deploying all of that capital across all stages of VC funding now requires a fresh new approach of time versus money; a means of figuring out which companies to spend our time on, how many deals per partner, and how much total capital to allocate per deal in this new environment. "Such large amounts of money creates *return on time* issues because VCs

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only have so many hours in the day and so many days in the week," says Pichinson. If you do the math, he's right. Multiply the number of hours required per company – say 15 hours a month for the good ones, 30 hours for the bad ones – to the number of companies each partner is responsible for (at least 6 to 8, sometimes more) and you quickly hit the wall.

Morover, early stage venture funds continue to stretch the definition of the term *return on time*, expanding the average invested dollar amount per partner from less than $25 million in 1997 to greater than $50 million today. Though down significantly from the more than $100 million to $150 million per partner for the largest funds during the Internet boom, the remaining large amount of investment capital has still made its impact on the industry.

One result of *return on time* pressures has been for certain funds to move increasingly into mid and later stage rounds of funding – thus creating a supply and demand imbalance. Though the supply of capital is increasing for later stage rounds, the size of an average later stage deal has actually decreased, with the average size of Series B and Series C rounds declining dramatically – from $15M to $8M for second rounds, and $20M to $10M for third and later stage rounds. (This is in stark contrast with the average size of seed stage and Series A rounds which have remained largely static between 2000 and 2005, at roughly $1 million and $5 million respectively.)

"What's driving ROT is that as funds are getting bigger they need to manage more and more portfolio companies, and in order to do new deals, they simply have to do more later stage deals that are already baked up." says George Hoyem, partner with Blueprint Ventures. Yet, as Hoyem also notes, the increased supply of capital at the later stage is not merely coming from within the VC community, but from new sources of capital entering the VC funding process. Buyout funds, hedge funds and private equity funds are all reaching beyond their comfort zones in order to deploy their own excess capital.

As a result of such capital pressure, valuations at the later stages have risen steadily over the past three years, from $20M in 2003 to $32M in 2005; yet, valuations at the seed stage level have remained largely constant at $2M per deal. That's good news for early stage funds, but more importantly, it means early stage deals have potentially greater opportunities for up rounds as they draw future funding from ever larger pools of capital.

Finding Religion

Return on time issues have not only resulted in shifts in capital however – ROT also forces us to learn how to spend our time differently. Traditionally, we spend significant time on troubled companies that are unlikely to significantly increase the returns of a fund. Thus, the desire to avoid losses siphons off significant time from other more profitable opportunities. One way to improve on ROT? Cut identifiable losses early.

A second way is to increase 'human leverage'. Venture capital has always been a hands-on business. Business judgment, experience and pattern recognition are key elements of a successful venture capitalist. These skills are honed through careful and close collaboration with our companies – and we must find ways to do this even more efficiently on a direct company level; without necessarily taking away from a partner's time spent on other portfolio companies or new deal flow. Experimentation in this area is ongoing, whether it's the use of venture coaches to assist companies, or the increasing number of firms focusing on interim CEO and CFO placements.

"The answer is that good new early stage VC funds are going to have to come into the market. In fact, some of the older guys may end up leaving the big VC firms and going back to venture investing the way it used to be," says Paul Deninger, Chairman of the technology investment banking group, Jeffries Broadview. This is already happening, with firms being created like LanzaTech by former USVP partner Lucio Lanza.

In fact, we're entering the latest era of reinvention in the venture capital industry, where an increasing number of small firms are being created to fill the gap at the earliest stages of venture capital; and limited partners are responding. New firms, such as Formative Ventures and Claremont Creek Ventures have already been established to serve the needs of early stage startups. Alternatively, some firms may choose to give up the lure of larger management fees in return for smaller and more flexible funds. Firms such as Sevin Rosen went from roughly $700 million in their previous fund to about $350 million in their most recent one.

Whatever the method, the reality of maximizing *return on time* issues indicates a return, yet again, to the essential value of seed stage investing, where early stage deals still abound, exits are becoming more frequent and valuations remain attractive and constant. As a result, *return on time* for early stage VCs will remain as rewarding and personally fulfilling as ever.

This is one in a series of monthly columns on seed and early stage investing that Labrador Ventures was selected to contribute to the *Venture Capital Journal.*

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