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How venture capitalists may impair the entrepreneurial ecosystem throughout their investment process[1]

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INTRODUCTION

Business newspapers and magazines often mythologize venture capital (VC) and VC-backed entrepreneurial firms such as Google, Groupon, Zynga, Dell, Intel, Microsoft, Federal Express, Home Depot, Starbucks, and many others. The mainstream popularity of venture capital is often manifested in television programs, such as *Dragon's Den* and *Shark Tank*, with the result that VC partners such as Michael Moritz, John Doerr, Vinod Khosla, and Peter Thiel are often glamorized beyond rationality and maintain 'rock star' status in the business world. VC partners have even been presented as a 'super breed' of financial intermediary. Mainstream media promotes VC by illustrating its spectacular successes, perhaps deceptively implying that these are the standard outcomes of VCs' participation in entrepreneurial ventures. However, this optimistic perception of the average VC firm is ill founded.

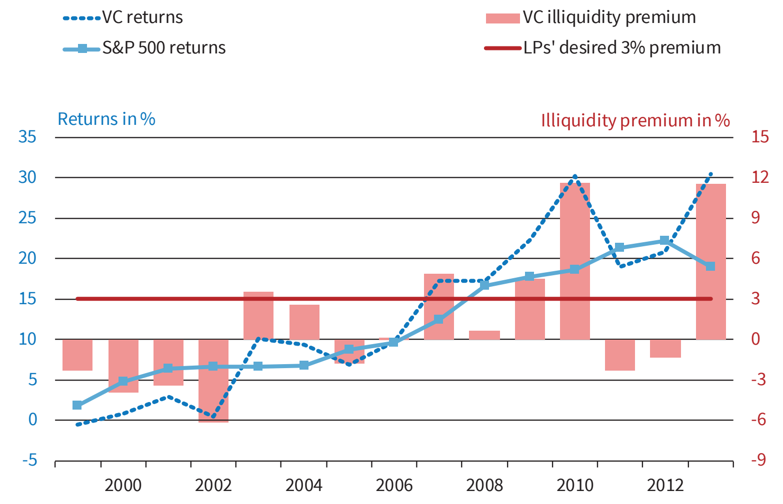
Today, VCs are breaking two promises: the one made to their own investors (called limited partners, or LPs) and the one made to entrepreneurs. First, the vast majority of VCs have broken the 'promise', or expectation, of outsized returns to their own LPs (i.e. pension funds, endowments, insurance companies, foundations, and so on). LPs expect to generate at least 3% more from VC investments compared with returns from public equities markets to compensate for additional risks and long periods of illiquidity, normally referred to as the 'illiquidity premium'. Yet the average VC firm is not able to meet these minimum requirements from LPs. For example, the illiquidity premium for the 15-year period between 1999 and 2013 totaled a meagre 1.2% in the United States (see Figure 1). While the VC industry often purports its value creation process to take the form of a J-curve, evidence suggests that the average VC firm's return performance may actually resemble an n-arc (see Figure 2). In reality, the J-curve may apply to only about 10% of VC firms. This n-arc reflects the reality of the chronically poor performance of the average VC.

In terms of operational statistics, VCs achieve a track record of about two-six-two on their portfolio of investee firms: two or even one sound investment, six investments that grossly underperform, and two total write-offs. In a nutshell, 'expert' investors are getting it right roughly one or two out of ten times. Of course, VCs naturally hope that one or two superstar returns will more than compensate for their underperformers. The poor performance of VCs is even more astonishing considering that these firms claim to spend substantial time and expense investigating investment opportunities, make significant value-adding contributions, and time public markets exceptionally well. It is no surprise that LPs are increasingly beginning to question the validity of the venture capital model, or simply avoiding this asset class entirely.

Most significantly, VCs have broken the promise of value creation to entrepreneurs; VCs are not as true today as they once were to their foundational maxim of being in the 'business of building business'. The media's promotion of VC has perpetu-

Figure 1

Financial returns from venture capital and private equity in the United States
1999–2013



Note: Calculations are made on the basis of data from Cambridge Associates (www.cambridgeassociates.com).
Source: Adopted from Klonowski (2018).

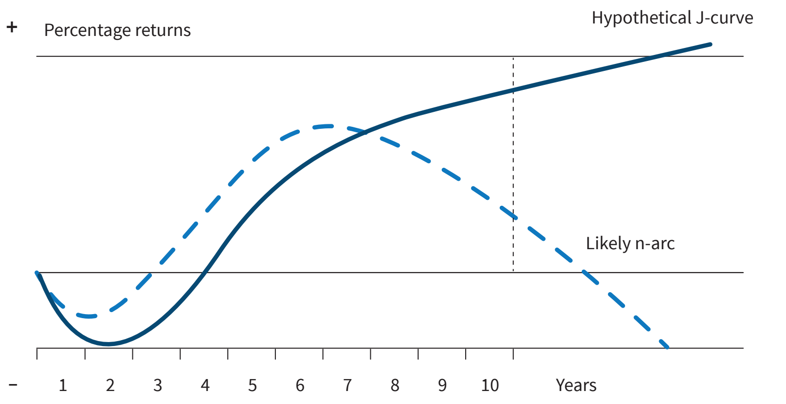
[1] This article is based on Klonowski (2018).

ated the view among entrepreneurs that their firm must obtain venture capital in order to make it big in the marketplace. Consequently, entrepreneurs internalize the belief that their ultimate goal is to raise venture capital, perhaps hoping that the underlying business will then develop itself. But an entrepreneurial firm's experience with the average VC is likely to be a disappointing endeavor in terms of both financial performance and value creation. Since VCs often exhibit a 'batting average' and 'spray-and-pray' mentality toward investing, they often quickly lose interest in underperforming entrepreneurial firms. VC investing resembles more of a roulette-like search for megahits, where underperformers (or VC 'casualties') do not really matter, rather than an orchestrated, well calibrated, and repeatable method of value creation. If the entire industry takes such a singular approach or exhibits this behavior on a large scale, VCs may actually impair the entrepreneurial ecosystem.

This article focuses on illuminating why the average VC firm may impair value creation in entrepreneurial firms. The analysis looks at the VC investment process, or the VC value chain, which consists of five stages: deal generation, screening and evaluation, deal completion, monitoring, and exit. It is along this value chain that potential value creation turns into value destruction, profits turn into losses, and robust returns become 'subprime' returns. This analysis confirms that the venture capital model is not just broken, but completely malfunctioning. The issue of VC underperformance is important to LPs, who provide capital to VCs by paying nearly USD 24 billion in annual management fees, and to entrepreneurs, who depend on VCs to provide valuable hands-on assistance that converts into entrepreneurial value creation. Reviewing the VC value chain can illuminate where value destruction or deformation is likely to occur.

Figure 2

Comparison of the distribution of venture capital returns across theoretical 'J-curve' and actual 'n-arc'



Source: Adopted from Klonowski (2018).

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DEAL GENERATION: CONFLICTS BETWEEN NATURAL AND ACCELERATED MODES OF ENTREPRENEURIAL DEVELOPMENT

Deal generation is regarded as one of the most important functions in the venture capital investment process. During this part of the VC process, entrepreneurs become the 'lifeblood' for VCs. And yet, if an entrepreneur is contacted by an interested VC firm, it may not be time to celebrate just yet. Why is that? First, VCs frequently look for entrepreneurial firms where they can 'unnaturally' accelerate their development, which is driven by VCs' short-term orientation. VCs typically believe that the decisions and actions of entrepreneurial firms must be governed by speed, while often wrongly assuming that natural business development can be changed or hurried. Natural entrepreneurial development, based on adaptation, maturation, and even failure, may be incompatible with the accelerated value creation promoted by VCs, which is often based on 'pump-and-dump' or 'growth on steroids' strategies. VCs fail to recognize that developing entrepreneurial firms at an excessively fast pace often destabilizes the business and magnifies risks. As such, this uncontrolled, haphazard, and chaotic growth may be fatal to entrepreneurial firms.

Second, while pursing the notion of accelerated value creation, VCs often overfund firms they ultimately choose to finance. This often causes entrepreneurial firms to increase their burn rate, delay testing new products and services (with real, paying customers), disperse their financial resources among too many projects, or overspend on unanticipated and superfluous items. Too much capital in a company's developmental stages can be detrimental to its inner entrepreneurial discipline, efficiency, and flexibility.

Third, VCs often exhibit a herd mentality when generating deals. If deals in a specific sector become successful, or if other expert VCs identify a particular sector of the economy as attractive, VCs uncritically pursue these opportunities by flooding the market with capital, effectively cannibalizing their own chances of success and initiating their own demise. In practice, however, the most attractive VC returns may actually be generated from the outlier sectors of the economy rather than those Wall Street has identified as attractive.

SCREENING AND EVALUATION: MISGUIDED ANALYSIS OF ENTREPRENEURIAL FIRMS

In order to filter through the vast majority of funding proposals from entrepreneurial firms, VCs engage in a process called screening and evaluation, or more simply, due diligence. However, there are numerous problems with VC due diligence, the most significant of which is that VCs do not have the relevant business experience. As a result, VCs have severe problems evaluating business plans or assigning appropriate valuations to firms. The vast majority of VCs come from finance, consultancy, or generalist backgrounds, have inadequate hands-on industry experience, and demonstrate limited executive know-how. Without suitable experience, VCs can rely only on their best judgment, loosely formulated opinions, personal intuition, and other subjective decision-making processes. Notable exceptions to this knowledge deficiency in the VC community are individuals with industry experience, individuals who have operated their own businesses, and professionals that come from different educational backgrounds, such as engineering, science, computer technology, and the like (this category of venture capitalists is referred to as business companions in Table 1). However, VCs with these capabilities make up less than 10% of the professional VC pool. Research evidence also confirms that VCs are overconfident investors who demonstrate a high probability of making wrong investment decisions.

Moreover, VCs' decision-making reliability and accuracy actually diminishes over time due to their relatively shallow pool of decision-making experience to draw from. Because their decisions are subject to delayed feedback, their decision-making apparatus cannot be properly calibrated. In addition to a lack of experience, VCs also suffer from multiple biases. VCs use cognitive shortcuts rather than relying on systematic, extensive, and in-depth research based on scientific evidence. VCs are not alone though, as cognitive psychology confirms that other professionals, including medical doctors, engineers, judges, and managers, also suffer from this cognitive impairment. Due diligence is often problematically discrete, focused on the minutia rather than the bigger picture, and disconnected, as advisors rarely talk to each other.

And finally, VCs notoriously reject firms that are later supported by other VCs and become successful; VCs frequently admit that they do not know which investments are likely to generate a financial windfall. A list of start-ups rejected by VCs includes some of the most prominent ventures in existence today: Apple, Airbnb, Cisco, Dell, eBay, Fitbit, Groupon, Twitter, and so on. While the reason for deal rejection may be perfectly justifiable after a thorough investigation of the investment opportunity, this rejection is often the result of unsubstantiated opinions and judgments reached shortly after a brief meeting with entrepreneurs or after a short glance at their business plan. Some of the greatest VC 'misses' in the United States are described by Bessemer Venture Partners in their 'anti-portfolio', perhaps the only honest disclosure of this kind in the VC world.

DEAL COMPLETION: INEQUALITY IN VENTURE CAPITAL CONTRACTS

The next phase of the venture capital process is deal closing or completion. Here, VCs and entrepreneurs engage in a lengthy negotiating process that culminates in the signing of a complex legal agreement; this agreement guides the future interaction between the two parties. There are multiple problems with this accepted legal construct that can later contribute to value destruction. First, VCs often take a standardized approach to venture capital contracting, and through these rights and provisions, they aim to control virtually every aspect of an entrepreneurial firm's decision making. This standardized approach to financial contracting often reflects venture capitalists' underlying weakness of being unable to properly assess the business, commercial, financial, and legal risks inherent in financing entrepreneurial firms.

Second, VCs often secure disproportionate and one-sided protections, with many clauses dealing with downside protections exclusively for VCs. The most draconian clauses include change of control provisions, the right to terminate the founder or the man-

Table 1

Profiles of venture capitalists and their value 'additions' across a range of business processes in entrepreneurial firms

VC profile \ Process	Capital budgeting	Project management	Training & development	Knowledge & IP management	Hiring & promotion	Resource procurement	Relationship management	Strategic planning	Business reviews	Monotoring & control
Financial propeller heads (58.4%)	★	★	★	★	★	★★	★	★	★	★★
Untested promoters (28.0%)	★	★★	★	★★	★	★★	★	★★	★★	★★★
Entrepreneurial disconnectors (7.6%)	★★	★★★★	★★	★★★	★★★	★★	★★	★★★★	★★★	★★★★
Business companions (6.0%)	★★★	★★★★★	★★	★★★★	★★★★	★★★	★★★★	★★★★★	★★★	★★★★★

Note: This table was prepared on the basis of a review of 250 profiles of venture capitalists from 11 major funds in the United States. The number of asterisks in the figure (ranging from one to five) below each business process represents the extent to which different types of venture capitalists have the background to provide valuable hands-on assistance to entrepreneurs in a specific business process.

Source: Adopted from Klonowski (2018).

agement team, and 'drag-along' exit rights, meaning the right to sell the entire entrepreneurial firm to a willing buyer. These excessive rights and controls in VC contracting may simply be overcompensating for VCs' insecurity and lack of expertise rather than actually addressing problems relating to VCs' poor access to information, or asymmetric information.

Last and most importantly, VCs believe that their strong and one-sided legal protections obviate the need to build a positive and nourishing relationship with entrepreneurs. This overreliance on legal terms rather than proper interpersonal rapport can be disastrous to entrepreneurial ventures if unanticipated problems arise. In the absence of proper interpersonal foundations between the two sides, destruction of the business value is likely to occur.

MONITORING: VENTURE CAPITAL'S SUBOPTIMAL ADVICE TO ENTREPRENEURIAL FIRMS

To distinguish themselves from other forms of financing, VCs promote themselves as active, hands-on, and value-adding financiers; this promise of hands-on involvement contains assurances of regular assistance for entrepreneurial firms. However, actual entrepreneurial experience with VCs presents a very different picture. In practice, this promise by VCs is not fulfilled, and entrepreneurs quickly discover that VCs overpromise and underdeliver. This part of the process is the one that can potentially destroy the most value in entrepreneurial firms. Most importantly, as noted above, the vast majority of venture capitalists lack real-life, business-grounded operations experience, preventing them from making meaningful, value-adding contributions to these firms (see the three suboptimal types of venture capitalists mentioned in Table 1: financial propeller heads, untested promoters, and entrepreneurial disconnectors; note that, of these three VC types, entrepreneurial disconnectors are the most user-friendly companions to entrepreneurial firms).

VCs have tight time constraints, and evidence suggests that the average VC is able to dedicate only a few hours per month to each portfolio firm, which is insufficient to make any significant difference or develop any meaningful relationship with the founders or managers. Furthermore, VCs may even impede entrepreneurial development by giving erroneous operational advice, providing ill-founded strategic guidance, or establishing unsuitable operational constraints. As their interactions with VCs increase, entrepreneurs often swiftly realize that they have more expertise than venture capitalists when it comes to their industry, products, and competitors. Many entrepreneurs also come to recognize that they are being unjustifiably 'forced' to take strategic and operational advice from non-experts, and that VCs too often act as 'financial bureaucrats' rather than value-adding participants in entrepreneurial development, which creates conflicts and value deterioration. As a result of their suboptimal involvement, VCs may actually expose investee firms to excessive operational, strategic, and financial risks.

VCs' standard *modus operandi* involves their alleged professionalization of entrepreneurial firms. This generic process often involves replacing the founding CEO, hiring temporary 'professional' managers who often leave after a liquidity event, employing various external consultants, and implementing stock-option programs primarily to preselected individuals, including their own appointed CFOs. These efforts are typically window dressing options focused on achieving a short-term value boost rather than long-term value creation.

Finally, it is important to note that, despite frequent claims by VCs, they do not create innovation in entrepreneurial firms. VCs follow innovation rather than precede it, and perpetuate innovation that already exists in entrepreneurial firms. In fact, evidence suggests that VCs' short-term determinism, focus on profit (the 'tyranny of the bottom line'), and quick-exit orientation often result in less innovation, commercialization, and investment in long-term R&D. VCs also appear disinterested in promoting innovation across the majority of industries where long-term development cycles and financial commitments are required. Instead, they are attracted to firms that offer incremental modifications to their existing products, and services that 'plug holes' in specific sectors of the marketplace. The most incriminating evidence of VCs' attitudes toward innovation can be seen in the fact that patent registrations actually decline or even disappear once VCs begin to work with their investee firms.

The most extreme manifestation of VCs' value-destroying nature can be found in the multiple lawsuits that have been filed against venture capitalists for a wide range of problematic and unethical behaviors. Academics confirm that lawsuits involve some of the biggest players in the VC industry.

EXIT: COMPROMISED VALUE REALIZATION IN VENTURE CAPITAL

The last phase of the VC investment process involves the actual conversion of the illiquid investment into cash. This end of the VC investment process is the conclusion of an often strenuous business relationship between VCs and entrepreneurs. It is important to reiterate that strong exit scenarios that culminate in superb value creation occur infrequently; compromised and distressed cases are a far more regular occurrence in VC.

The average entrepreneur will observe multiple adverse behavior patterns in venture capitalists, including exiting prematurely, losing focus on entrepreneurial firms' long-term strategic and operational objectives in order to seek a short-term increase in profits and cash flow, and window dressing or 'dressing up the bride'. In preparation for exit, VCs may attempt to improve the bottom line by aggressively reducing expenses through eliminating the sales department, product development, and other business functions. While such practices may be acceptable to VCs, they are inevitably destructive to the long-term success of an entrepreneurial venture.

CONCLUSION

Although the average VC today is not interested in change, entrepreneurs may be able to trigger a change in their behavior by completely rejecting VCs as a prime or even desirable mode of entrepreneurial finance. It is important to remember that, despite the media hype and euphoria about VC, VCs make a relatively small contribution to entrepreneurial development. In the United States, for example, only one in 1,541 entrepreneurial firms receives VC, which is less than 1% of entrepreneurs' financial needs (in Germany: 1,609; UK: 2,370; France: 3,146). And yet, however small an impact they have, VCs can be detrimental to entrepreneurial firms no matter how glamorously the media portrays these 'rock stars of the financial realm'.

REFERENCE

Klonowski, D. (2017), *The Venture Capital Deformation: Value Destruction throughout the Investment Process*, New York: Palgrave MacMillan.