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A Second(ary) Chance for Venture Capital

Troubled VCs need to rethink how long they invest in startups; many should fund early and then sell to a secondary firm after a few years

By Auren Hoffman

There's plenty of fretting in Silicon Valley and beyond over the venture capital industry, how broken it has become, and what needs to be done about it. Proposed solutions abound, with some favoring a government bailout, others saying the ranks of venture capitalists need to be slashed dramatically, and some proposing the creation of a market where equity in startups is bought or sold like shares of publicly traded companies. Each has its merits and weaknesses.

But in my view, what's needed is a fundamental rethink in the way startups get backing. VCs need to take a fresh look at when they invest, and for how long. VCs and other investors that have expertise in early-stage companies ought to invest at the outset for a few years, but then sell to companies that specialize in—and have more to offer—more mature companies. To understand why this approach makes sense, consider the shortcomings of the existing model.

Currently, many investors buy stakes early on and then add to those investments in later years. For instance, a typical early-stage firm might invest $3 million to $5 million in what's known as an A or B round. Then over the life of a startup, they'll put in another $3 million to $5 million to maintain their share of ownership and the rights that come with it. The model has been sacrosanct for the past 30 years.

A 10-Year Life But the wait for an exit, through an initial share sale or a buyout, can take a decade from the time of the A round. Remember that most VCs have a "life" of about 10 years. And if, say, a VC invests in a company in year three of its fund, there's a good chance the firm will be managing the investment past the life of the fund.

What's more, the time to exit is getting longer, not shorter. Companies like YouTube, purchased by Google (GOOG) for $1.65 billion less than two years after it was founded, are rare. In the future, big wins will more closely resemble Zappos, an online apparel retailer. Zappos is incredibly well run, and all VCs wish it were in their portfolio. But Zappos is having its 10-year anniversary this year, and it might be another few years before its exit.

Longer waits are bad not just for the VC calculating the return on investment (ROI). They also result in impatience on the part of limited partners such as university endowments that invest in venture firms. It's also demoralizing for individual venture capitalists. There are many well-regarded VC partners that have never had an exit. Some venture capitalists are leaving the profession altogether and firms are shrinking.

Here's where secondary VCs can play a vital role. These firms, most of which did not exist 10 years ago, specialize in buying stakes in private companies from VC firms. Some examples include Saints Ventures and W Capital Partners, which are among the most successful firms this decade. Secondary firms now account for roughly 3% of the VC market, but their clout is increasing as they do more deals. San Francisco-based Saints now has more A-list portfolio companies than most traditional VC firms. Its investments include Facebook, eHarmony, and QuinStreet.

Increased Return It helps that increasingly, many VCs are open to selling their positions to secondary firms. While selling early will lessen the long-term value of investments that become hits, it could increase a VC's actual return on investment by letting them realize returns much faster—say, three years rather than 10 years.

What's more, increased dependence on secondary investors will let VC partners focus on what they do best. Different skills are required for an A-round investor than for a late-stage investor. A venture capital firm should deliver and focus on its core competency and move on. Just like startups change CEOs as they mature, shouldn't companies change VCs as they mature? If there is a good startup CEO, shouldn't there also be good startup VCs? Some people can take a company from startup idea to billion-dollar business, but most need to be replaced along the way—this is true for both management teams and board members.

Early-stage VCs could focus on early-stage issues and later-stage VCs could focus on later-stage issues. Their investing timelines could be shorter, they can better plan for the future, and they'll need to keep less undeployed capital, or "dry powder," on reserve. They'll probably also do more deals.

My guess is that firms that invest in an A round might not necessarily invest in the B round. Instead, they might look to unload some or all of their shares in the C round.

Take Gains Early

I know a few angels who already follow this model. One sold half his interest to a particular VC in the C round and later sold the rest of his interest to that same VC. He made about 250% in three years. That's not bad—especially when compared with the current market. Sure, he may miss a big pop in share price. But he's become a very successful investor through his strategy of taking gains early.

Why don't more VCs and angels follow this strategy? As an angel, I have a lot of good advice for a company that's just getting off the ground, but if I'm intellectually honest, I don't usually add much value after the second venture round. Still, I haven't followed the model I outline here. Maybe it's time I should.

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