Chapter 3. Venture Capital

Questions and Problems

1. The early venture capital funds were organized as closed-end funds. More recently, most venture capital funds are being organized as limited partnerships. What do you see as the key differences between the two forms that help explain the shift?
2. Refer to Figure 3.1. What factors led to the dramatic increase in commitments to VC funds in 1978?
3. How do the reputations of fund managers, investors, and entrepreneurs bear on the efficient operation of a venture capital fund? How do you think venture capital contracts might be different when a manager, investor, or entrepreneur does not have an established reputation?
4. In the late 1990s, the carried interest of some of the leading venture capital funds increased from 20 percent to 30 percent, and the funds have tended to shift more of their focus to making somewhat later-stage investments. These changes occurred at the same time that the number of venture capital funds was increasing, total capital commitments to funds were increasing, and business angel investing was growing and became more organized. Can you think of a competitive reason why the carried interest percentage might increase at the same time these other changes were taking place? Can you explain why investors in the funds might be willing to accept the higher carried interest? Finally, can you think of any way you might be able to test your conjecture?
5. Venture capital firms normally try to solicit investment capital at the same time they are looking for deals. They also can extend the life of a fund for several years beyond its planned liquidation date. How might these practices contribute to enhancing the value of the fund? How might they affect the kinds of investors the fund seeks and the kinds of ventures it invests in?
6. You are planning to start a $30 million VC fund. You have two other partners (three GPs in total), and plan to impose a 2 percent management fee and 25 percent carried interest. The fund will have an 8 year life, with the first four years being for finding and making investments ($7.5 million per year) and the second four years for managing and harvesting. On average, your investments will and return 30 percent annually and run for four years, i.e., investments made in Year 1 will be harvested in Year 5.
    a. What is the annual management fee per GP?
    b. How much carried interest will each GP receive in each of the years 5-8?
    c. What is the LPs IRR, assuming their full $30 million is put up at Time 0?
7. Figure 2.3 shows clearly that VC firms tend to cluster geographically. What are some of the reasons for this phenomenon?
8. Describe two ways of mitigating the adverse selection problem that can arise between VCs and entrepreneurs.
9. Explain why LP investors in a VC fund might want to contractually limit the following:
    a. The addition of new GPs at the VC firm
    b. Fundraising by the GP for another VC fund
    c. Investment of the GP’s personal funds into a portfolio company