

THE LITTLE BOOK

of

VENTURE
CAPITAL
INVESTING

*Empowering Economic Growth
and Investment Portfolios*



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with WESLEY A. WHITTAKER

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*To my daughter Alexandra,
the hardest worker I know.*

From my point of view VC is the ultimate in supply-side, and this Little Book captures this in a way not done before.

—Art Laffer, Laffer Associates

The only VC-related book I'm aware of, providing a lively and contemporary go-to synopsis on the state of the VC industry, the ins-and-outs of how to invest in the space, and a forward look at what's needed to re-ignite the VC growth engine.

—Frank J. Caufield, co-founder, Kleiner Perkins Caufield & Byers

Acknowledgments

It occurred to me as I started writing this book that I wanted to draft this section and compare it with how I felt about the contents when it was completed. In a book with as many invaluable sources as *The Little Book of Venture Capital Investing*, it goes without saying that there are many people from whom I am constantly learning and who have greatly influenced my thinking and views. *Venture Capital Investing* owes a great deal to Wesley Whittaker, my talented co-writer; thank you so much to John Wiley & Sons for the referral. Thanks to editor Debra Englander and her terrific colleagues at Wiley for believing in me as a first-time author. A special thank-you also goes out to my partners and professional staff at Gerken Capital; thank you Carla, Pankti, Anthony, Valerie, Pierre, Elizabeth, Peter, Laura, and Yaneth for the faithful support that allowed me the time to indulge in this first book-writing journey, about a business that I continue to enjoy. The industry's guardian angels have blessed me with financial success, so I can truly say that I still work as hard as I do because I was fortunate to leverage something that I am really passionate about into a career.

I also wish to give recognition to all the VC industry pioneers, current pathfinders, and tomorrow's trailblazers who never cease to amaze me with their savvy determination and survival skills. I see no limit to what is possible by America's entrepreneurs when unbridled to do what they do best.

Special thanks also goes to the wealth of sources I accessed to write this book, where there is such an abundance of industry data and intellectual capital available for a first-time author to access.

Lastly, I give special recognition to my parents who started me on the path to investing when they seeded my first investment portfolio at age 12 (Litton Industries, LTV, and PSA—sadly now all defunct enterprises).

In closing, I trust that this *Little Book* will be helpful in some small way to small business owners—who make up 93 percent of all businesses in the United States, who work tirelessly and risk so much. They deserve better access to growth capital and the opportunity to become one-percenters.

An Introduction to Venture Capital Investing

Occupy Wall Street protesters are planning to occupy the subway in New York City; because if there's one place to confront the nation's wealthiest 1 percent, it's the subway.

—Conan O'Brien

Who Are the 99% and Why Are They So Angry?

In September of 2012, I saw a headline on the inner pages of my *Wall Street Journal*, "Occupy Movement Turns 1 Year Old. Its Effect Still Hard to Define." Under the headline were details of arrests for disorderly conduct and photos of what looked like the aftermath of a tornado. Clues to the protestors' incongruent discontent were scattered through the crowd on professionally printed signs and hand-painted placards in fractured disarray.

The CRISIS is CAPITALISM

IPO = I'm Pissed Off

Where is the CHANGE we voted for?

I'm so angry, I made a sign

The obvious disconnect was that the protestors were actually beneficiaries of the successful ventures of the 1 percent they so willingly maligned. The entire Occupy protest was conceived, coordinated, and thoroughly documented on various forms of social media, from Tumblr to Skype to Facebook to Twitter. The protests were photographed on Apple iPhones and Android phone

cameras. The protestors kept up their energy by chugging Red Bull and eating LUNA bars. They filled Zucotti Park with nylon popup tents from Ozark Trail, slept in North Face sleeping bags, kept warm with Coleman heaters while sipping Starbucks lattes. Some signs were hand-painted, but many were printed professionally at FastSigns or FedEx Office. FedEx also delivered the Guy Fawkes masks and tricorner hats that were ordered from eBay. Donations to feed and support the long-term “committed” protestors were raised through KickStarter. Corporate logos adorned hoodies, shirts, shoes, and denim jeans everywhere. No matter how socially aware and progressive the 99-percenters fancied themselves, this disgruntled and unfocused multitude seemed blissfully ignorant of the fact that if it wasn’t for capitalism, none of the resources they had relied on to fuel their righteous indignation would even exist. This global exercise of political democracy was only made possible by the economic democracy afforded by the brand of capitalism which has been practiced in America since the latter half of the twentieth century. As American philosopher and educator Mortimer Adler wrote in the preface of *The Capitalist Manifesto* (New York: Random House, 1958), which he co-wrote with Louis Kelso, “Democracy requires an economic system which supports the political ideas of liberty and equality for all. Men cannot exercise freedom in the political sphere when they are deprived of it in the economic system.”

In other words, the Occupy protestors were right to be angry at the excesses and abuses of the elitist few, but their anger and frustration had been hijacked by those with a subversive political agenda against the only economic system that has actually improved the lives of all mankind. Fraud, deceit, and corruption in both the financial system and in the government regulatory sector are the true culprits. The crony capitalists definitely need to be brought

to justice in order to restore the integrity of the real free market system; however, history has proven conclusively that socialism, communism, and anarchy are not the remedy for the excesses of criminals and evil doers.

The irony of the entire Occupy movement is that it was made possible by the very thing it decried—capitalism—and venture capitalists (VCs) in particular. Each of the companies represented by the countless logos and slogans that pervaded the Occupy protests and their multiple locales benefited, early in its conception, from an infusion of capital made by private investors who saw enormous potential and bore personal financial risk to fund the particular technology, product, or service that enabled the movement's effectiveness and the protestor's comfort. The return on that investment came about through persistent work, the maximization of available resources, the public's perception of a fair exchange of value, and YES a lot of luck. It is the true manifestation of the American Dream.

Capitalism, especially in the free market paradigm, is not the zero sum game the Occupy evangelists would have you believe. Every time people take a risk with their own money and end up winning, their good fortune does not mean that someone else lost. That is a ludicrous proposition believed only by the ill-informed or the leftist ideologue. That is the Big Lie told to fuel the envy and bigotry of the ignorant in order to promote a political and economic agenda. There is a much larger percentage of Americans who have achieved financial success than 1 percent of the population. Neither is 99 percent of the population shut out of opportunities that are still afforded to those who live in this greatest of nations. That is a propagandist distortion of statistics to the grossest extreme for purely nefarious reasons. The political paradigm put forth by the inciters behind the Occupy movement calls for sublimating the individual for the good of the collective; surrendering the inherent greed of private property rights

for the altruistic enrichment of the community; and achieving a fair and equitable outcome for society by redistributing the ill-gotten gains of the successful in order to supplement the lifestyle choices of the underachievers. Really?

The demonization of the economically successful is not at all about fairness and equality. It's about political power and economic control; the seizure of political power by those who cannot possibly gain it through reasoned public discourse and the theft of wealth that they desire but are unwilling to obtain through traditional, legitimate means. It is not fair. It is not democratic. It is unethical and it is totally antithetical to what it means to be an American.

America was built on the premise that if you have a dream, set your goals, and work hard to achieve it, you can accomplish anything. How did we become the global vortex for demonizing success? How does transforming our commercial and financial centers into landfills of consumer excess serve to bring about constructive resolution of the gulf between the have-lots and the have-nots? Whining pithy slogans based upon entitlement expectations and offering no comprehensive solutions are not synonymous with civil disobedience. We must confront the fact that the American people have allowed a few sociopathic narcissists to steal their dreams along with their money. And we must refuse to accept the hysterical, illogical, and unfounded rhetoric that it is "unfair" and "evil" for an individual to use her own vision, analysis, courage, and due diligence and to invest her own money to underwrite someone else's dream of starting a private business, creating jobs and contributing to the economic health and social well-being of the community.

What Is Venture Capital Investing?

Venture capital investing is a lot like the old baseball adage: You win some, you lose some, and some get rained out. There is no secret formula or guaranteed path to success, especially in the field of venture capital investing. Many venture capitalists have lost their entire investment when the once-brilliant ideas they funded foundered in the competitive marketplace or got torpedoed by even greater innovations.

Sand Hill Road, the legendary 3.5-mile stretch of concrete that runs east from I-280 to El Camino Real in Menlo Park, California, is the financial epicenter of Silicon Valley. It is littered with the fading memories of companies and grand ideas you've never even heard of. It is also home to many early investors in businesses who went on to become household names; calculated risks made many of them quite comfortable.

The returns on the initial investment are just the tangible rewards for being a venture capitalist. Many who live and work along this short stretch of road, which skirts the north side of Stanford University, are driven by more than money. Reid Hoffman is a perfect example; the 45-year-old partner at Greylock Partners has been in on the initiation of over 80 startups including such game-changers as PayPal and LinkedIn. He sits on the board of directors for Kiva.org and is known as the consummate connector in Silicon Valley. He genuinely cares about people and making the world a better place. As LinkedIn CEO Jeff Weiner says of Hoffman, "His true north is making a positive, lasting impact on the world in a very profound way."

Hoffman is a self-identified liberal who still drives the 2002 Acura he purchased with his share of the PayPal buy-out. He

probably understands the angst underscoring the Occupy complaint, but it would be an incredible stretch of credibility to paint Reid Hoffman with the scarlet “1 percent” label.

How does one become a venture capitalist? For many, like Bill Joy, it was a natural progression. Born in 1954, Bill grew up in the northern Detroit suburb of Farmington Hills, Michigan. He obtained a bachelor’s degree in electrical engineering from the University of Michigan and by 1979 had completed a master’s degree in computer science from the University of California, Berkeley. He also holds an honorary PhD in engineering from the University of Michigan. As a graduate student at Berkeley, Joy designed and wrote Berkeley UNIX, the first open source operating system with built-in transmission control protocols for the Internet protocol (TCP/IP), which is the basic communication backbone of the Internet. He founded Sun Microsystems in 1982 and was a key designer involved with a number of Sun technologies, including the Solaris operating system, the SPARC microprocessor architecture and several of its implementations, and the Java programming language. As an inventor, Bill is named on more than 40 patents. In February 1999, his many industry contributions were recognized in a *Fortune* magazine cover story that called him the “Edison of the Internet.”

His accomplishments, the product of his keen intellect and inquisitive nature, resulted in substantial financial rewards. This prompted him to pursue interests in other areas, and in 2005 Bill Joy joined Kleiner Perkins Caufield & Byers, one of the first Sand Hill Road VC firms and the company that had provided the startup capital for Sun in 1982. Joy helped develop KPCB’s strategy of funding game-changing technologies that broadly address the twin problems of climate change and sustainability. His ventures included investments in wind, solar, and thermoelectric power generation; low-cost electrical energy storage; renewable

fuels and green chemicals from nonfuel sources; low-embodied-energy materials; and energy-efficient electronics. He now serves as a Partner Emeritus at the firm.

My VC journey is different from Bill Joy's and Reid Hoffman's, but I believe we share some traits in common: a strong work ethic, a willingness to invest, the strong desire to make the world a better place, and an innate ability to take a setback as a learning experience and press onward. I was 16 years old when I experienced my first business failure. It was a summertime sole proprietorship called Paul Bunyan Tree Service. Due to my lack of experience in risk assessment and due diligence, I lost all my hard-earned gains paying for damages caused by a tree coming through a client's roof. It was an expensive lesson, but business fascinated me, and I was determined to learn from my mistakes.

I earned a bachelor's degree in economics from the University of Redlands and went on to receive an MBA from the Southern Methodist University Graduate School of Business and a master's degree in international business from the American Graduate School. After finishing my university studies, I was hired by The Bank of California, where I monitored privately-held companies, and subsequently worked with a pioneering emerging markets investment manager, London-based GT Capital Management. I then self-financed a start-up called TCG, a telecom consulting engineering practice, which I sold to PricewaterhouseCooper's consulting practice.

This helped set the course of my life, and later I landed a job as head of Venture Capital Investments with Wells Fargo Bank, where I serendipitously developed one of the first U.S. fund of funds with Anthony Moore, one of my current partners at Gerken Capital Associates (GCA). Some of the best ideas are born by complete accident. Sometimes the best path is the one you take alone. For example, while with

Wells Fargo, I had been presented with opportunities to invest in a number of “risky,” early stage companies, including Sun Microsystems and Microsoft. My investment acumen aside, the organizational guidelines that governed investments of the group at that time would not even permit me to present these opportunities to the group’s Investment Committee. The unintended consequence was the creation of one of the first U.S. venture capital “fund of funds.”

I did a stint at Montgomery Securities Venture Capital and was subsequently hired to become a co-GP with Prutech, the venture capital investment subsidiary of Prudential Securities, founded by another one of my current GCA partners, Hugh McClung. As one of the largest U.S. venture capital funds, Prutech was responsible for completing 50 IT and biotech sector early-stage and expansion-stage investments, and was one of the first VC funds to pioneer corporate partnering as a co-investment strategy. Eventually, I was asked to head up Prudential Securities Technology Investment Banking Division.

I left Prudential in the late 1980s, thinking I was ready for an early retirement. After a much needed vacation in South Africa, one of my favorite destinations, the entrepreneurial bug bit once again. I founded GCA in 1989 as an alternative asset fund management firm, with particular focus on alternative assets and emerging markets. Version 1.0 of our business was to act as a seeder to “next generation” alternative asset fund managers, backing more than two dozen teams. GCA morphed circa 2000 into its present v. 2.0 business—managing and advising alternative assets (private equity, venture capital, and hedge funds), and merger and acquisitions advising. I think what differentiates our approach toward investing is that we take a very active and hands-on approach toward managing assets and, as a privately owned boutique, have the flexibility to move on investment opportunities very quickly. We are not reluctant