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100 YEARS
1908-2008

VENTURE CAPITAL CONFERENCE

JANUARY 9-10, 2008



A CENTENNIAL EVENT

HARVARD BUSINESS SCHOOL

CENTENNIAL VENTURE CAPITAL CONFERENCE

January 9–10, 2008

Conference Insight Report

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About the HBS Centennial

Our Centennial celebration is largely about ideas. Harvard Business School faculty, working with their academic colleagues at Soldiers Field, Harvard, and around the world—as well as with practitioners—have designed a total of 14 colloquia to push the frontiers of knowledge. In the best traditions of HBS, these colloquia (presented in small classroom settings over the course of three calendar years) combine theory and practice to shape both the art and science of management.



Conference Agenda

JANUARY 9–10, 2008

WEDNESDAY, JANUARY 9, FOUR SEASONS

6:00 p.m. Reception & Dinner
 Panel Discussion
 Professor Richard Tedlow interviews Bill Draper, Pitch Johnson, and Arthur Rock.

THURSDAY, JANUARY 10, COMPUTER HISTORY MUSEUM

8:00 a.m. – Registration & Continental Breakfast

9:00 a.m.

9:00 a.m. – Panel I: What Does Strategy Mean in the Venture Capital Industry?

10:15 a.m. Moderated by Professor David Yoffie

Panelists:

- Tim Draper, Draper Fisher Jurvetson
- Paul Maeder, Highland Capital Partners
- Gary Rieschel, Qiming Venture Partners

10:45 a.m. – Panel II: Where are the Best Opportunities for Venture Capital

12:00 p.m. Investing and How Should Firms Organize their Global Activities?

Moderator: Professor Josh Lerner

Panelists:

- Sumir Chadha, Sequoia Capital India
- Andy Goldfarb, Globespan Capital Partners
- Tina Ju, Kleiner Perkins Caufield & Byers China
- Neil Rimer, Index Ventures

12:00 p.m. – Lunch

1:15 p.m. Welcome: Donna Dubinsky, Board of Trustees, Computer History Museum

Address: Jay Light, Dean of the Faculty

1:30 p.m. – Panel III: How Is the Opportunity Set Changing?

2:45 p.m. Moderated by Professor Felda Hardyman

Panelists:

- Dan Levitan, Maveron
- Terry McGuire, Polaris Venture Partners
- Ray Rothrock, Venrock
- Mark Stevens, Sequoia Capital

3:00 p.m. – Panel IV: Wrap-Up: The Future of the Venture Capital Industry

4:00 p.m. Moderator: Prof. Bill Sahlman

Panelists:

- Jim Breyer, Accel Partners
- Peter Lawrence, FLAG Capital Management
- Art Marks, Valhalla Partners
- Peter Wendell, Sierra Ventures



Introduction

The Harvard Business School begins its 100th anniversary year by hosting the Venture Capital Conference. This forum brings together some of the best business minds in the world to focus on the state of their industry today and to look ahead at the challenges and opportunities of the next decades.

The VC Conference is one in a series of 14 alumni and practitioner forums the School is hosting as part of its Centennial celebration. Through it, HBS honors the important contributions made by its graduates—who today are estimated to make up more than 20% of the world’s venture capitalists—to the development of the VC industry. The contributions of HBS faculty and alumni to the development and shaping of the industry cannot be over-emphasized: they included pioneering players who launched important firms and invested in some of society’s most important companies. As VC increasingly becomes a worldwide phenomenon, moreover, HBS will continue to have a decisive impact on the national and international economy.

It is appropriate that the conference should be taking place in Silicon Valley. This all but unique confluence of ideas, research, financing and human resources has served as a matrix in which venture capital has either invented or revolutionized whole industries and changed the US—and now the world—economies forever.

The conference addresses some major issues and questions:

- What strategies are most effective in creating a top-decile firm?
- Will those strategies also work in the face of new challenges and a global environment?
- If not, why not, and how should the industry evolve new strategies?
- How are opportunities for VC changing with globalization?
- How should VC firms organize to take advantage of new opportunities in their home counties and abroad?

Those attending the Conference represent the leaders of the venture capital industry. It is our hope that listening to the speakers and panel discussions and engaging in dialogue will stimulate further discussions, generate new ideas, and nurture the community of HBS graduates and others in the VC industry worldwide.



Panel I: What Does Strategy Mean in the Venture Capital Industry?

Overview

Many in the venture capital industry have argued that it has no strategy, it just follows the crowd. The members of this Panel Discussion believe that strategies of various kinds—to differentiate, to locate and hire in foreign countries and cultures, to build trust, even about whether to go global or not—are a necessity now that the VC industry operates in a globalized world. Among the major points discussed:

- [How venture capital firms strategize and differentiate](#)
- [Global strategy—a new form of herd behavior?](#)
- [How to scale up the partnership to the global operations level](#)
- [Protecting venture capital operations from legal shortcomings and corruption](#)

Panel

Tim Draper, *Founder & Managing Director*, Draper Fisher Jurvetson
Paul Maeder, *Founder & Managing Partner*, Highland Capital Partners
Gary Rieschel, *Founder*, Qiming Venture Partners
Moderator: David Yoffie, *Professor and Senior Associate Dean*,
Harvard Business School

Moderator's Introduction:

According to the data that my colleagues have put together on the venture business over the last 25 or 30 years, the VC industry tends to be characterized by relatively low average returns over the long run. This is a pretty depressing set of statistics, something that no one in the industry should feel proud of. But in general, what we would argue in the world of strategy is, "Success fundamentally depends on your ability to create a relatively unique position in the market." When all firms cluster in the same relative position, we tend to see low average returns. And if there was ever an industry characterized by herd behavior, it is the venture industry.

In this context, do venture capitalists have real strategy, or, for the most part, is the industry following the crowd? If we believe that there should be some degree of differentiation across the firms represented here in this room, how do you differentiate? Should you focus on industries where there are network effects, or should you avoid industries where there are network effects? How do you think about global strategy? This is the ultimate global business; should we think about ways to differentiate in the way global opportunities are pursued?

Should venture capitalists have strategies, and if so, what kinds?

TIM DRAPER OF DRAPER FISHER JURVETSON:

We lucked out when we did the Hotmail deal. Within three weeks, we had 100,000 registered Hotmail users in India. Before that, the idea of doing business with people in India was ludicrous. We realized, right there, that we were going to be able to do business all over the world, and so this perky little world of venture capital that we were doing in Silicon Valley and Route 128 was going to be everywhere. Ideas would



come across all sorts of places. We looked at each other and we panicked. We said, "Oh my God, there are going to be startups everywhere! How do we be everywhere at once?"

So, we took stock of things in 1997 and 1998. People were very anxious to put money in venture capital at that time, and we took advantage of that and set up remote offices in a lot of different places. Once that happened we thought, "This is great. We can see all the deals, we would be a hub and they would be the spokes, and they would show us all of these great deals." It turned out that they all got to know each other too, and they started to benefit from being a part of this great network. So, we started to do things for our entrepreneurs that we were never able to do before. You blink, and now we have 36 offices around the globe and we have these huge network effects.

We would see an entrepreneur in London and we could compare them with an entrepreneur in China, in India, in the Silicon Valley, and then we could decide which one of those four we wanted to back, or which group of entrepreneurs we wanted to back. Once we fund a company, we can introduce these entrepreneurs to people anywhere in the world and that has become a strategic advantage.

We are really happy that it has worked out this way; we had some success along the way when the rest of the world in the Silicon Valley was saying, "Why would I invest now in 2002–2003 when I will just get a lower price later?" We happened to be traveling, and so we kind of leapt into a couple of deals, Skype and Baidu, which were neither in the Silicon Valley nor on Route 128. That had to do with just not being in the Silicon Valley, not listening to the mantras of the venture capital business.

Not only are we happy with the way that it has worked out, we are incredibly optimistic about the future because venture capital, a relatively small industry before, is now spreading throughout the entire globe. It is changing the way governments look at the world. Geographic borders are collapsing and governments have turned from dictators to salesmen, trying to pull business into their country, trying to pull venture capital entrepreneurship into their country. Every country except one: the United States of America, which seems to be pushing businesses away with every new political mantra.

I am hugely optimistic about the world and what is going to happen. Entrepreneurship has done extraordinary things for the world. In India the caste system is being completely blown up by entrepreneurship. Entrepreneurs who come from nothing are now becoming enormous billionaires, and they can break through all the castes. When there is this kind of change happening there will be huge returns, and I would not hesitate to invest more money into various venture firms because people are going to do very well.

Session Quote

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– Tim Draper, Founder & Managing Director,
Draper Fisher Jurvetson



PAUL MAEDER OF HIGHLAND CAPITAL:

Should venture firms have strategies? Yes. Until the first half of this decade, venture firms did not have strategies. They differed in tactics. We were professional service firms and we competed based on our networks, experiences, and reputations. Above all, we competed on “earliness” and hard work, and by “earliness”, I mean that the older firms did better because they had bigger networks and longer reputations and the first guy to a deal did better. That is not strategic differentiation: there is only strategic differentiation if the statement to the opposite also makes sense. “I will not work hard” is not a strategy. “I will work hard” is therefore not a strategy.

But a funny thing happened in the first half of this decade, as we licked our wounds and fixed our broken portfolios: the entrepreneurial community became international. For the first time in the history of this young industry, we are faced with a strategic choice, a major strategic choice: whether to globalize or not. It is apparent to us at Highland, and obviously to Tim, because when I fund a startup in Cambridge, it is as likely to have a competitor startup in Shanghai, Bombay, Geneva, Lausanne or London as it is in Menlo Park or Waltham. We have to know what is going on everywhere, we need to internationalize, and that raises a really important question. How do you take an industry that is inherently local and inherently non-scalable and globalize it?

It is a nightmare. It is a local business because the way we get deals and the way we help companies is through local knowledge and it is non-scalable because we have these silly things every Monday where we all sit around a table and kick around decisions. So, how do you do it? There are three choices for recruiting internationally and I do not think that any of the three is particularly adequate: 1) a wholesale approach where you affiliate with a group in a foreign country; 2) you hire offshore; 3) you train locally and then send people out to the hinterlands.

Affiliating with a group has disadvantages:

- you do not have brand control
- you don't get true local insight
- you don't maintain the culture of your firm
- you do not learn a lot about that foreign environment
- when it is time for the second fund, the group you hired is just as likely to walk away and say, “Thanks very much for helping us raise our first fund!”

Hiring offshore is also very challenging. Integrating people from an offshore location into your process is tough, and you are just as likely to put a competitor into business as you are to build an offshore arm.

Session Quote

We are incredibly optimistic about the future because venture capital, a relatively small industry before, is now spreading throughout the entire globe. It is changing the way governments look at the world. Geographic borders are collapsing and governments have turned from dictators to salesmen, trying to pull business into their country.

– Tim Draper, Founder & Managing Director,
Draper Fisher Jurvetson



The third approach is to train locally, spend two to five years integrating people into your process and your firm, and then send them off. That is great because the risk is lower, and because it is a more stable approach. It obviously has enormous disadvantages because it is time-consuming, and if you lose that person, you have just invested five years in nothing.

The shift presents a real challenge to recruiting and managing a firm. How do you make decisions? How do you fund these foreign groups? Do you have a separate fund? If you do, you can share carry, but fundamentally you are creating a separate operation, and the synergies and the information flows that you are trying to seek with internationalization can evaporate fairly quickly. Do you keep it in one fund? If you do, people will not have a local incentive for their local productivity. How do you manage decision making? We now have an office in Geneva and an office in Shanghai. No matter what time we pick for a partners' meeting, someone is going to be up in the middle of the night. These are very tough strategic questions. For the first time in this industry's history, we really have to think about them. We will differentiate ourselves from one another because different firms will use different approaches to this problem.

GARY RIESCHEL OF QIMING VENTURE PARTNERS:

At the time when Masa was in Japan, the strategy was to find people you could trust in the venture business. They were not just trying to ship you all their lousy deals and get you to be the next sucker, but to find people who wanted to do things. What you had to do was do things early enough with them so that you were not buying someone else's problem. The strategy became one of only working with people who had a lot of experience in the venture business, and one of trying to get the entrepreneurs to work together.

The other strategy was to do only things related to the Internet. If you were a licensed enterprise software company, we did not talk to you. If you were a communications equipment company or semiconductor company, we didn't talk to you. We got the services side of the Internet business. Those were the strategic decisions and they worked out well.

On differentiation; there are way too many smart people in this business for anyone to wind up being the only person who figures something out for a long period of time. This change for the venture business mirrors the change in the IT industry. When I worked for Sequin in the 1980s, it was obvious that it would be three to four years before the folks at DEC, IBM, Apollo, etc., would figure out what the other startups were doing. Now, every major IT company has a group that does nothing but interact with the venture capital world to figure out what idea they missed internally and how to buy it as cheaply as possible once it's proven.

The VC industry is now going through exactly the same thing. In the early 1990s, you could do a stealth deal and you could keep a company quiet, and you might be one of two or three investors looking at a sector for several years. Now? I swear

Session Quote

Integrating people from an offshore location into your process is tough, and you are just as likely to put a competitor into business as you are to build an offshore arm.

– Paul Maeder, Founder & Managing Partner,
Highland Capital Partners



people have tracking devices on their cars. It is crazy. You go from a \$300 million investment in cleantech to \$4.5 billion in about a six-year period.

Session Quote

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– Gary Rieschel, Founder, Qiming Venture Partners

One of the things the industry has to deal with is that it has lost some of that ability to really be early. Now, you have to approach things in a much more aggressive way by establishing your presence at the early stage. It is very hard to dabble now in sectors. You are either all in or you are not, and I think that that is another strategic point.

The idea to me is that you take your pool of money and you put people who you trust in the market. Trust is the key word. It cannot be people who think about deals in a way you do not know. They cannot

be people you have not worked with. They cannot be people who tell you that they want to invest a million dollars and then you spend the next six months figuring out if you can really get the deal done. You have to figure out how you establish a trust system, and to us that means that a senior partner will always have to go to a new geography. It is the only thing to me that makes sense in cutting down a lot of the unnecessary overhead of running a globalized venture capital firm.

Global Strategy—A New Form of Herd Behavior?

MODERATOR:

Is “global strategy” the new form of herd behavior?

PAUL MAEDER OF HIGHLAND CAPITAL:

The answer is maybe, but so what? There are other herd industries. Gold mining is a herd industry. From a public policy standpoint, it is a good thing because if that first gold miner had gone to San Francisco and found gold but nobody else came, there would still be a lot of gold underground. If Bill Draper and Arthur Rock had been the only firms to open up a venture operation in California, where would Silicon Valley be today? It is good when the little T-cell that grabs onto a virus raises its hand and says, “Come help.”

The problem we have in the industry is that the gain is too high on the feedback loop. Sometimes the whole herd goes right off a cliff like a bunch of lemmings, and sometimes the whole herd goes in one direction and does not notice opportunities off to the side. The issue from a public policy standpoint is not whether herd behavior is good or bad. All free markets are herd behavior.

Now, how do you turn down the gain from a feedback loop? One would hope that one way is through experience and that some of the partners who have been around for a longer time can say, “Hold your horses, let’s not jump in headlong. These

Session Quote

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– Paul Maeder, Founder & Managing Partner, Highland Capital Partners



prices are getting a little crazy. We are not really sure this is going to work. Let's slow down a little bit and diversify a little more." Actually, globalization is really good for that, as is industry diversification. In our firm, we invest in three industries, not one. When the prices look really silly in IT, the healthcare guys call us on it and we say, "Oh yeah. You are right. It is getting warm around here, let's hold off." We stopped investing in communications in 1999 for that reason.

GARY RIESCHEL OF QIMING VENTURE PARTNERS:

I am not saying it is a bad thing, but this industry does not manage itself on a kind of an "on or off" basis. It is always on, and it raises a question of what level of control you have inside your own firm or your partnerships that mitigate some of that risk. Some people have none and it works out well for them, because their track records have been good enough over time. Some firms do not have that luxury.

TIM DRAPER OF DRAPER FISHER JURVETSON:

We tend to be pioneers. In many cases, we find the gold and we stake out our claim. In other cases, we are the pioneers with the arrows in our back. But there is a bigger picture here and it's that this is probably one of the best uses of resources that you can possibly have. There are many venture capitalists out there, and hopefully more and more are spreading money in very efficient ways into lots of different places. Bankers do this a little bit with loans, which is much more efficient than a government taking money and putting it into things that will be innovative for society.

This whole confluence of activity between venture capitalists and entrepreneurs is great. It is good for the world that venture capitalists make mistakes occasionally, that they go in too strongly, that they burn themselves and realize, "We really should be in there but maybe just not be as strong as we were." Perhaps we are flying into China too quickly and putting too much money into one or two key, big entrepreneurs instead of spreading it more broadly, but China is booming. There are a billion people there and there are at least a billion business ideas. It is probably worth putting an awful lot of money there. Even with all the venture capitalists and all their money go flying into China, I still do not think that we are overfunding it.

Audience Q&A

Going Global

Q1: Let us say you are a homegrown non-US venture firm, in China, India, Europe or elsewhere, and you are thinking that you need to be international and global. How would you advise the firm about partnering or moving to get closer to the US market?

Paul Maeder of Highland Capital:

Other than what Tim has done and what Peter Brooke did, there has been precious little merger and acquisition activity in this industry. I think that is going to come. You could look at this industry and say that it is in its early stages, that it will consolidate the way investment banking did in the 1930s and '40s. Eventually, there will be some global dominant firms, so you have to align yourself with someone.

Session Quote

Growth is not necessarily a good thing for the venture capital industry. The social good that comes from it, as well as the financial gains, is fantastic. But for each individual firm, you do not have to get big.

– Gary Rieschel, Founder, Qiming Venture Partners



Gary Rieschel of Qiming Venture Partners:

I do not think that you have to align yourself with anyone. It is a question of which you want to be. If you want to raise \$50 million in Silicon Valley and all you want to do is do 10 \$5 million investments over the next five years and you are really disciplined about doing only that, you might end up as the most successful VC in Silicon Valley, depending on which 10 deals you end up doing.

The same thing goes for overseas. If you are known as the person who really has his finger on the pulse of the local market, then when the global VC flies in, you wind up getting to meet them and they wind up bidding up all your deals and you end up being happy. One of the problems is that this is not a market share business. Growth is not necessarily a good thing for the venture capital industry. The social good that comes from it, as well as the financial gains, is fantastic. But for each individual firm, you do not have to get big. There is no necessary benefit to running a billion dollars versus \$50 million.

Q2: My question that is related more to syndication strategy. With funds getting bigger, we are seeing a trend where more firms are doing 100% of the A-round and then syndicating the B-round. Entrepreneurs are looking at this, saying, "I could give up 50% to two firms or give up 35% to one firm." The flip side of syndication is that you have more bets on the table. You are getting help from other partners and in a head-driven business, one would argue that maybe syndication is the right answer. How do you think about syndications in series A?

Tim Draper of Draper Fisher Jurvetson:

I used to say that if we are interested in a company, we should take the whole thing. But I realized that it is advantageous to have other people around the table helping make the company successful. So I like syndicating every time we make a new investment. I am a real believer in it because you can get many more people pulling for you.

Q3: What has been your success rate of pairing founders with CEOs who can help them scale the business? Has this pairing been a factor in your strategy?

Tim Draper of Draper Fisher Jurvetson:

I tend to not bring in professional CEOs very early on, because I feel that a company must have a certain emotional energy. Now, if the founder who comes to us is purely technical and has no interest in running a business, then pairing him up with somebody before we put money in is usually a better strategy than allowing him to run astray and then bring somebody in to fix it.

In a startup, they have to figure out their business model. And they need that creative spark plug, that one guy who is the founder who has this whole vision to weave his or her way, into finding the business model that works. Once the business model is really working, then hiring in a professional CEO is sometimes successful.

Q4: Listening to you, it sounds as though venture investing in the United States is absolutely not where it's at. Is that an extreme interpretation of what you are saying or do you feel that venture investing in the US dead?



Paul Maeder of Highland Capital:

It is not dead by any conceivable stretch of the imagination, but we are only five percent of the world's population and we had this great little gig to ourselves for the last 20 to 25 years. This little engine for job creation and industrial competitiveness and having fun careers and so forth—this was our little secret. The rest of the world figured it out while we were sleeping in the first half of this decade. Now that they have figured it out, things will never be the same again. We all have portfolios where three quarters of our companies are doing offshore development right out of the chute. If you put me to sleep in 1995 and woke me up today, I would say, "Boy, this is a different planet." It is a totally different game, and a totally different world. We cannot ignore the other 95% of the world and we certainly should not, because there is a ton of opportunity there. Those people are, in some cases, better educated and more motivated; they represent very attractive investment opportunities.

Tim Draper of Draper Fisher Jurvetson:

Things are going to get better a lot faster in other countries. I think that the US government is just pushing businesses away, but Silicon Valley still has a real attraction, it is a real magnet for immigrants who have great ideas because they know that there is at least a lot of venture capital money here. They may come to Silicon Valley, get their money and then go back home and run their business. And now that we have offices everywhere, I have tried to be geography-blind for the deals.

Gary Rieschel of Qiming Venture Partners:

Everyone likes to talk about the death of things and so we have the death of Silicon Valley. But we do healthcare in China and nothing in China in the bioscience area is within five years of the state of the art, or the work done in Berkeley, UCSF or Stanford. Not even close. On a broad base, the technology platform is nowhere near the innovation level of what you are seeing here.

The problem is that this is going to change. If you get very comfortable and you decide that you are going to sit here because you have this great franchise, it will be eaten away within 10 years. Sixty-five percent of the world's material science engineers are going to come from China; petroleum engineers, 75%. That means if you're doing a cleantech deal, you're going to be recruiting in China. You cannot simply repurpose a semiconductor engineer to become a petroleum material science engineer for the cleantech companies. It does not happen. The VCs can repurpose themselves, because we can talk ourselves into thinking we actually know something about a new area, but the engineers actually have to make it work.

Scaling Up Partnership Arrangements For Global Operations

Q5: Each of you has a group of partners who sit around together and make decisions on deals, and that is an incredibly important part of what you do. How do you scale that, particularly from a size and a geographic perspective?

Tim Draper of Draper Fisher Jurvetson:

What we have tried to do, since we are all interconnected with groups around the world, is to have each of those groups go through the same things that we had to go through in the Bay Area. They go through some of the issues that we may have had five or six years ago and so it is easy for us to advise on how they might want to deal with certain issues because we have been through many of them. That has been very helpful.



Paul Maeder of Highland Capital:

That is exactly what I was talking about when I mentioned that venture capital is a nonscalable or largely nonscalable business. When somebody calls in from Bhutan and says that they have a wonderful deal, how do we deal with it? It's a real problem. You can only get excited about a deal if you can smell it and be there in person. Video conferencing and phone calls and memos just do not do it. So ultimately, there is no substitute for people just racking up the miles, getting on an airplane and going to look at deals with their partners and bringing the companies back to have them present.

Session Quote

It is very easy when you are six time zones and an eight-hour flight away to start to suspect the worst when you hear about the decision, and the only way to overcome that is by just having dogged communications.

– Paul Maeder, Founder & Managing Partner,
Highland Capital Partners

Many people might think that biggest concern would be, "Will we lose control, let remote offices become autonomous, and have that lead to poor decisions?" That is not the biggest issue. The biggest issue is when we tell a person in a remote office that they can't do a deal even though they're very excited about it because we're not convinced, and then they become alienated and say, "God, I can't convince those guys of anything. Why am I dealing with them? I'll just spin out. I'll join a local firm." Then you lose all the benefits of what you have tried to accomplish with internationalization.

It results in friction, and the only way to overcome that friction is by being fanatical about communications, and we are getting better at that. It has taken us a while to figure that out, by doing a lot of flying around, having a lot of group strategy meetings, and making sure that trust exists, making sure that people do not drift away from their link to the core firm. It is very easy when you are six time zones and an eight-hour flight away to start to suspect the worst when you hear about the decision, and the only way to overcome that is by just having dogged communications.

Q6: If you think back to when you started building your firms and adding new partners, and you look at your success rates, how have you successfully recruited? Has it been from promoting within or hiring externally?

Gary Rieschel of Qiming Venture Partners:

When we grew the SoftBank Group, everyone was operational, which I still think is the best experiential background for what the entrepreneurs need. The caveat was that every new person who joined, who had not been a VC before could not go out and lead deals for that first year. We had a chance to fix this in China. Everyone who deploys capital for Qiming has been an investor in China for at least three years prior to joining. Most of the mistakes come in those first years because you do not have that sense of, "You know what, this just does not feel right" because you are experiencing it for the first time.

Tim Draper of Draper Fisher Jurvetson:

We have done that a little differently and every one of our partners is still with us. I have always looked at it as a network. I have this thing in my head that when I was just me, it was a point. When John Fisher joined, we had a line. When Steve Jurvetson joined, we had a triangle and then we went into three dimensions and multiple dimensions. Every time we added somebody I thought, "How is this person



going to add something new to our operation? How are they different from us and can they push us in a new direction? Can they take our firm and push it into a new dimension?" That was the driving force behind every one of my partner hires. We now have the luxury of having more time, because we bring people on as analysts, and then move them into associates after they go to business school. We have more time to determine which of those people will become partners, but we are still looking for people who push our firm into a whole new direction.

How To Protect Global Venture Capital Operations Against Corruption

Q7: Some of these countries, particularly China, do not have well-developed legal systems to deal with the legal issues, accounting issues, and corruption in the distribution networks. How do you deal with that? How do you protect yourselves and your limited partners per your fiduciary duties?

Tim Draper of Draper Fisher Jurvetson:

I learned that one major lesson from my father. He went into India where there was a lot of corruption. This is the way that he described it to me. He went around India and there was always somebody saying, "Well, if you pay me, then I can get you to this guy," or "If you pay me, I can get you this guy." Dad said no and no and no and no. Finally, they realized, "This guy was not going to pay any graft. Go ahead, let him do it." I think that's the strongest message you can send. Look, there are going to be corrupt people in the world. You can try to work some strange thing with them, or you can just say, "Well, forget it. I'm just not going to do that." If you say, "Forget it. I'm not going to do that," your life becomes much easier. That's the corruption question.

As for the governance question, the US has the laws- so many laws. They have laws that overlap. They have laws to a fault. Some of these countries have just recognized that the free market system is going to make their country flourish. You are not allowed to dump tea into the Boston Harbor- that is a law that has been on the books for 200 years. Do we really need that? We have too much bureaucracy here. There is always some constituency giving you a hard time for everything you do. You go to another country, and the sky's the limit.

Gary Rieschel of Qiming Venture Partners:

Speaking specifically about China, the reason the distribution for the pharmaceuticals network is set up the way it is in China is that over half of the doctors' compensation comes from the medicines they prescribe. The entire distribution network is set up to provide kickbacks on procedures. That's something that the Chinese will have to fix. But if you're going to invest in distribution in China and you expect it to look like the folks in the States would be providing that, you're going to be terribly disappointed.

They executed the head of the FDA in China. The reason they did that was very simple. Everyone takes a cut, all the way down to the courier handling the documents. How do you litigate that? How do you try that? So they shot the guy. He tried to commit suicide in January and they stopped him and said "No, no, no. We get to do this." Very public. Very strong message. I'm not a huge fan of capital punishment but how do you make some of those changes? I think it is a message that they are serious.



Paul Maeder of Highland Capital:

With respect to governance, we made the mistake of trying to mold non-US documents to look like US documents to get the same protections with respect to voting rights, redemption and liquidation preferences, and anti-dilution protection. We just frustrated ourselves and alienated our co-investors. We learned that only one law matters and that is the law of trust. The best deals in the United States are handshake deals. Yes, you pay for them because the lawyers need to get paid. We would not want them going out of business, but offshore it is the same thing. You have to trust your co-investors and fundamentally trust the people you are investing in. Don't groan too much about the documents and the governance. Just be reasonable.

Q8: People are more important than ideas, yet all we hear about strategy is either geographic strategy or technology strategy for VC firms. Is it possible to have any kind of strategy for choosing entrepreneurs to back in your firms?

Gary Rieschel of Qiming Venture Partners:

I think the reality is VCs are generally lazy about diligence, especially as it relates to people. We fall in love with the idea, and then the person who brought us the idea. We fall in love with the package, and then your diligence winds up being scaled to convince all your other partners and everyone around you that this is a good deal. In the US, you can generally get away with that because there are safeguards. The attorney, the legal infrastructure, accounting infrastructure, the Silicon Valley or Route 128 network effect—you can compare. In China, if you do that, you are going to have a problem.

I have a 20-question rule relative to doing a deal in China. You know the game Twenty Questions? You sign your term sheet and you go off and you're negotiating your deal. If you talk to an entrepreneur and every single time, he says "Oh yeah! Oh, you wanna know that? Okay," then he isn't forthcoming. You have to walk away. The way you deal with entrepreneurs winds up being completely different. That is one thing you absolutely cannot apply a standard template against.



Panel II: Where Are the Best Opportunities for Venture Capital Investing and How Should Firms Organize Their Global Activities?

Overview

Silicon Valley and Route 128 are beginning to seem like narrow venues for an industry that is rapidly becoming an international business. How are some of the best venture capital firms responding to the global challenge? The participants in this Panel Discussion have taken diverse directions: to different geographical areas, different organizational arrangements, different approaches; here they share their experiences and track records. Among the major topics discussed:

- [How VC companies approach globalization](#)
- [Silicon Valley: can it be duplicated? Does it need to be?](#)
- [New strategies, new approaches: the “sweet and sour pork” paradigm](#)
- [Dealing with the “faraway” phenomenon: maintaining trust within VC organizations](#)

Panel

Sumir Chadha, *Managing Director*, Sequoia Capital India

Andy Goldfarb, *Co-Founder*, Globespan Capital Partners

Tina Ju, *Managing Partner*, Kleiner Perkins Caufield & Byers China

Neil Rimer, *Co-Founder*, Index Ventures

Moderator: Josh Lerner, *Professor*, Harvard Business School

Moderator's Introduction

In our research we have looked at the history of the venture industry in the United States and asked this question: “What kinds of batting averages and slugging averages have different venture firms had on the basis of whether they are relatively more or less specialized?” The lesson that comes out of this research is that specialization seems to be associated with higher batting averages. It is also associated with higher slugging average and higher IRRs. This suggests that there is some real cause for concern about doing stuff in too many places. One thing to emphasize is that much of the deterioration of performance seems to happen when the people themselves move from just doing one industry or one area and spread out more generally.

When you consider things from a geographic perspective, what's clear is that even when you just count every fund equally, there is a big disparity between the average rate of return from the typical developed country and that from the typical undeveloped or developing country: basically 12%, which is not spectacular but respectable, versus 4%, which is pretty miserable. When we look at the weighted average, we see something interesting: the bigger funds, by and large, in the US and Europe have done better, while in the developing world, it seems that the bigger funds have done significantly worse. It seems the market has not done well in choosing where to channel resources.

We will dig into these issues and understand how groups are dealing in a practical way with such problems. Our panelists will give us highlights on how their organizations are approaching globalization.



Approaching Globalization—the View from Inside

TINA JU OF KLEINER PERKINS CAULFIELD & BYERS CHINA:

China is probably the first and only market where we have established a true inter-national presence. We have officially launched the first Kleiner Perkins China fund this year and we have an independent partnership with a locally based team to manage the fund with our investment decisions. The local team basically decides on capital deployment. At the same time, we strive for full integration with our US partnership.

I joined Venture TDF in 1999 and became a venture capitalist in China about eight years ago. For the last eight years, we really focused on building a local franchise and becoming a top tier local venture firm. During that time we noticed that the trend of venture capital was becoming more global and we wanted to service our local entrepreneurs in China better. I think we're the first in China to go from being an independent fund to becoming part of a US venture fund.

With that background, I want to come back to our globalization strategy for Kleiner Perkins; we do not have a cookie cutter, fixed strategy for each of the international markets. We think globally but we execute locally. For our entrepreneurs and for our portfolio companies that need global resources, we have the platform to help them reach a global network and global resources.

We also have a very strong international interest in India, where we have deployed the capital from our US main fund and we have a US-based partner that has strong Indian heritage. We work closely with Indian investors that have had strong experiences in the domestic market. So, for India, strategy is different from China. For Europe, we have established connections with local partners to gain insights on the local entrepreneur environment and we do make direct investments, similar to those in India, into European companies.

SUMIR CHADHA OF SEQUOIA CAPITAL INDIA:

In 2000, we started a firm called Westbridge, focused on India and US-India ventures. Then we went through the "nuclear winter" in India, where in 2000 there were about 20 venture funds and by 2003, most had shut down or left the market. It was a very tough time. We raised our second fund for India in early 2005, then merged with Sequoia in 2006.

It felt like there was a complete famine of venture capital in India two or three years ago. Today, there is a feast and unfortunately, the last time there was a feast in India in 2000, most of the funds didn't return capital in India in the venture business. Last year, we saw eight or nine new funds set up to do early stage venture capital and there are worrisome signs of overheating. We have already seen that in a lot of the deals, so it is probably a time to be nervous about venture capital in India.

Session Quote

There was a complete famine of venture capital in India two or three years ago. Today, there is a feast and unfortunately, the last time there was a feast in India in 2000, most of the funds didn't return capital in India in the venture business.

– Sumir Chadha of Sequoia Capital India



ANDY GOLDFARB OF GLOBESPAN CAPITAL PARTNERS:

For Globespan Capital Partners, the process of going international was organic and it started outside the US. We were previously affiliated with JAFCO, which was at that time the largest venture firm in Japan. We were the US arm of the money that we had from overseas institutional investors and we evolved our investor base from purely Japanese to a global base. We felt there was an opportunity for US companies to access Asian markets and we believe it was a very valuable way to look at the global economy.

NEIL RIMER OF INDEX VENTURES:

Index Ventures is partially a result of a carefully planned strategy and part happenstance. I was born in Canada but I grew up in Switzerland and attended Stanford University. I went to work for Montgomery right after Stanford and then went to HBS. After HBS, I decided to go back to Geneva and start a firm there because I thought it would be more exciting.

The thesis that my partners and I had was that there wouldn't be another Silicon Valley anywhere else in the world and so we should stop trying to find it. Second, institutional sources of capital for funds would, over time, care less about geographic distribution or diversification and just look at returns. If they are a top decile investor, then they will look at the top decile fund and if there happens to be an Israel fund and a European fund in there, then that is their asset allocation. If they are all US firms then they're 100% US, and that forced us to compete.

Can Silicon Valley be Duplicated Anywhere in the World?

MODERATOR:

Given the challenges that ventures have faced outside the confines of Silicon Valley and the Boston area, is this just a fad that's going on now, where groups are rushing overseas, or is there really a logic to what's taking place?

ANDY GOLDFARB OF GLOBESPAN CAPITAL PARTNERS:

The number of people and the amount of energy may be disproportionate to the realization of the opportunity, but the opportunity is not a fad. You cannot suppress global communications. If you look at the IPOs in Japan and you look at the opportunities in India and China, dreams are being created for a whole generation of entrepreneurs. There is capital available for them and there are even sociological factors that help them cope with failure. Once you create the opportunity for entrepreneurial activities to foster and the resources to develop, you cannot put the genie back in the bottle.

NEIL RIMER OF INDEX VENTURES:

The real question is not where the next Silicon Valley is. The real question is where can you make venture returns and that, I think, is more a function of supply and demand in the different markets around the world. If you can go to a certain market and put your fund to work more effectively there because of your experience, your relative position competitively in that market, and there's enough deal flow, then you should be there.

*MODERATOR:*

Do you agree that there is only one Silicon Valley? From what you are seeing in Shanghai and Bangalore, is this really just the US all over again, just at an earlier stage of development?

TINA JU OF KLEINER PERKINS CAULFIELD & BYERS CHINA:

I don't buy that there is only one Silicon Valley, because history always repeats itself. I want to throw out some data for people to make their own judgment whether the opportunities are real in China and that should help us to realize whether we can create a Silicon Valley in Asia, whether in India or China. This year, the first trillion dollar market cap company was created in China. It is an oil company called Petro China. One can criticize the exaggerated market cap; it is because of the very small float on the domestic stock exchange, which sort of exaggerated the valuation of the company. But, nevertheless, it is a market cap that is higher than Exxon Mobil plus GE combined, and there will be more and more close-to-trillion dollar companies coming out of China. Four or five of the top ten companies in the world are now China-based. Although these are not the types of companies that venture capital will have access to because they are really state-owned enterprises, these give you a sense of scale of the enterprises in China.

Session Quote

The real question is not where the next Silicon Valley is. The real question is where can you make venture returns and that, I think, is more a function of supply and demand in the different markets around the world.

– Neil Rimer, Co-Founder, Index Ventures

Another point is the type of venture capital-backed firms. We participated in companies that started small but at the end created a \$50 billion market cap. We invested in 15 companies; nine of them have exited. Out of these nine companies, six have a combined market cap of \$50 billion. These include companies like Ali Baba, which is still a record-breaker with a market capitalization of \$26 billion on the day of the IPO. When LPs and other VCs hear opportunities like this, it excites people to bring talent back into China, whether it is entrepreneurs or fund managers. When you have exciting opportunities, it attracts the best talents.

NEIL RIMER OF INDEX VENTURES:

I just want to rephrase. I'm not saying that there won't be returns in other parts of the world. What I mean is that the concentration and geographic proximity that you have in Silicon Valley, where the practitioners, the entrepreneurs, the sources of capital, the research is so closely assembled, I think it's hard to find that somewhere else.

MODERATOR:

Do you buy that, Sumir?

SUMIR CHADHA OF SEQUOIA CAPITAL INDIA:

I think Silicon Valley is light years ahead of India. India is a very tough place to do business compared with Silicon Valley. Closing deals takes three months. We still find many lawyers in India who don't understand liquidation preference. I am not



saying it will not get there and certainly, we hope it will because we are investing in India, but putting aside the hype, it is very different from Silicon Valley today.

The other thing is that an average return is going to be really poor in India, because of the point that Andy made: the supply of capital way exceeds the demand. Clearly there will be firms that will make money, but it is hard to imagine the average being very good for everybody. It is just hard to imagine, because when you see lots of examples like those we are seeing in India today, a lot of pre-revenue companies get funded at \$20–\$30 million pre-money in small markets. Take the online advertising market. It is a \$60 billion market in India. Total online advertising is \$20 billion here, but people are funding companies at \$20–30 million pre-money in that market that are pre-revenue.

MODERATOR:

We know that, in general, markets where there are big inflows of money, returns tend to go down the drain due to all the money chasing deals. What do you do in that case? You just sort of sit on the sidelines and wait five years until it's another nuclear winter? How do you think strategically about moving in that kind of market?

SUMIR CHADHA OF SEQUOIA CAPITAL INDIA:

One thing we're doing is a lot of non-tech investing. We invested in a construction company, we are doing a lot of things that are out of the normal range of what most people considered traditional venture capital, because some of the areas are very well fished and so we try to avoid some of the hot areas and go to other areas or industry sectors.

MODERATOR:

Europe has got many issues, but dramatic overfunding is probably not one of them. How do you operate in Europe?

NEIL RIMER OF INDEX VENTURES:

Actually, that is not a bad thing from my perspective and I do not see it as likely to change either. I think there is enough entrepreneurial activity and enough interesting work being done in labs and spinoffs available from large companies. For the practitioners who are dedicated to the space, I think it is a great place. Let's not forget, we have a broad definition of what is Europe. Europe from our perspective stretches from Norway to Israel and from the West all the way to Russia. It is a big geography, there is a lot to do there. It is a lot of work and you cannot afford to sit back and assume people will show up on your doorstep, even if you are based in London.

Creating New Strategies for Globalizing VC Firms

MODERATOR:

There are different models and approaches to the question of strategy. Sumir and Tina, you have been on both sides of the fence in terms of having been the independent local firm as well as being a part of a larger global organization. What are your thoughts about the challenges and tradeoffs from having seen both sides?



TINA JU OF KLEINER PERKINS CAULFIELD & BYERS CHINA:

I would like to quote my partner, Ted. He used Chinese dishes to describe different types of international strategy. The first dish is Kung Pao Chicken, which is basically the parachute, fly in, fly out strategy to make investment. That is what Kleiner Perkins did. We made two investments in China two years ago and that was the first stage.

The second one we called the dragon roll; we hired junior partners who understand local markets, either from the US or from China, and had them running around looking for partners and looking for co-investment opportunities. We did that for about six months.

The third one is the Peking duck, which we never considered: basically we use our own capital from the US and we become an LP and find the best performing fund and hopefully, they take our capital and we just become a side watcher and try to learn from there. We decided not to pursue that. I think for a long time we were evaluating the franchising model which is basically looking for the dream team of local partners. The challenge was that when Kleiner Perkins identified each of the partners to be part of the dream team, everyone had existing obligations, whether they were the CEO of a very successful company to be listed or they were existing managing partners of existing funds, so no one was really willing to leave their post.

The last model is the one we have today. We call it the sweet and sour pork. We finally found a team that we are happy with locally, so we combine what we call a very solid local team and integrate with a very solid American team.

SUMIR CHADHA OF SEQUOIA CAPITAL INDIA:

When we raised our second fund we had a very limited track record. It was very tough because there had not been a venture fund raised in India for four or five years. It was sort of missionary work raising it from LPs and it was taking a long time. It was hard but we got a fantastic set of LPs. So one result is that you spend less time fundraising and that is a big positive, because you can spend more time with the companies and in investing that is beneficial for everybody in the system.

The second result I would say is a lot more global connectivity, understanding of trends in different markets and better access, which really does help. Finally, as Tina mentioned, it is really being able to take in an entrepreneur who wants to take a company global, wants to get access, customers, and markets and really making that happen in a way that we could not as a stand-alone Indian firm. So, it means a lot of positives for the entrepreneurs and for us as well.

Overcoming the Distance Gap

MODERATOR:

One of the issues that larger buyout funds have struggled with has been creating or sustaining that trust within the organizations. How do you overcome the issue—that you have many partners sitting in San Francisco and you are sitting thousands of miles away—in terms of the comfort level around different deals?



TINA JU OF KLEINER PERKINS CAULFIELD & BYERS CHINA:

It took us two years to get to know each other and then last year was really very intensive integration. It is really about getting to know your partners well before you sort of get married. The trust that we have for each other is that we understand that our US partners have always told us, "We don't understand China. We think it is strategically important for us, but we are the first ones to admit that we don't understand China. Therefore, we are looking for a group of partners that we trust locally to make decisions on our behalf. But you know, we do not want to just lend the brand to you, but we really want to have a true integration." So, there is a constant balance between autonomy and integration.

Session Quote

Working with our US partners, the number one issue is really to maintain the quality of trust. That is much more important than some of the nuances about whether we have weekly or daily calls and e-mails. As long as both sides have the best intention to make it work, we can always refine the mechanism, the process.

– Tina Ju, Managing Partner,
Kleiner Perkins Caulfield & Byers China

For one example, we conducted our meetings in Chinese before, but because we now have Kleiner Perkins partners, we conduct our meetings in English. That changed the dynamics a little bit. I do believe having a global presence but with a locally decision-based mechanism is probably the right thing to do long term.

MODERATOR:

You guys must have thought about some of these same issues as well. So, how did you think through this process and these tradeoffs? In the case of Globespan, you started as a global organization from day one.

ANDY GOLDFARB OF GLOBESPAN CAPITAL PARTNERS:

In terms of the people on the platform, the people have global perspective and international backgrounds. In terms of the processes, we designed the system from the beginning of "identifying the problem" as an opportunity on how to communicate. Therefore, as we've transferred or extended our global investing, we use the same methodology that we use for US investing overseas, with some appropriate modifications. When you have local activity, you have to be sensitive to local practices and know what you can't do.

A couple of examples. You mentioned the language and I think that does play an important role in Asia; people do not want to express contradictory opinions, people do not want to ask questions, whereas in English, it is a much more comfortable way of expressing yourself. Reference calls are standard protocol in the US but less common in Japan or in Asia. But it is surprising that if you actually do it, people are more comfortable sharing information. You want to have the common framework of language so that people have that trust.

Having a methodology that we set up upfront has delivered a more comfortable way of integrating international talent. Those are the different elements that have been important to us; the people, the process, and then the purpose. That's helped us maintain our consistency.



NEIL RIMER OF INDEX VENTURES:

We started in Geneva for historical reasons but also because we realized that deals would be distributed across a wide geography. So the important thing was quality of life for your partners: a good place to live, a decent climate and a place where people would not refuse to come to work; and then the ability to cover that whole geography with flights that will get you in and out of places easily. We kind of recognized that that meant signing up for a whole lot of travel. We set up London several years later and that gave us one other place in Europe where we could interface with companies. I think of ourselves as almost a one-office firm that happens to have some offices further down the hall. But we really tried to integrate that way and I don't think this would be possible without technology.

Session Quote

I am not saying that a Silicon Valley will be created in China the way Americans define Silicon Valley, but I think being in China is an opportunity of a lifetime.

– Tina Ju, Managing Partner,
Kleiner Perkins Caufield & Byers China

MODERATOR:

That is quite a different approach. Tina, you emphasized the importance of having that initial trust, but how do you keep the lines of communication open? Does that involve actually traveling or can you just do that by using the videoconferences and all those kinds of stuff?

TINA JU OF KLEINER PERKINS CAULFIELD & BYERS CHINA:

I would say working with our US partners, the number one issue is really to maintain the quality of trust. That is much more important than some of the nuances about whether we have weekly or daily calls and e-mails. As long as both sides have the best intention to make it work, we can always refine the mechanism, the process.

SUMIR CHADHA OF SEQUOIA CAPITAL INDIA:

I have the advantage of being based in California, so for the last seven or eight years I've been traveling back and forth. In India, a lot of our companies have been US-India companies; often the CEO will sit in California with the customers and the offshore services are performed out of India. By the nature of our portfolio, we have had more integration with the US, and the Indian domestic market has taken off much later than China's, so it's a more recent phenomena. We are doing a lot more India-India deals recently, but we made a lot of face-to-face interaction; there is no substitute for that.

Audience Q & A

Q1: How long do you think it will be until you can come back and tell us about how the experiments you are conducting are working, from the point of view of the returns that you have delivered versus other experiments in the venture business? How are you going to avoid the mistakes of the past?

Andy Goldfarb of Globespan Capital Partners:

If the firm's objective is to experiment running overseas then maybe they will close



it in a couple of years. American companies have that problem of not being committed to the market and that makes it very difficult. There is value when you are dealing with an international entrepreneur and you bring them to the US. There are a lot of valuable insights that they can get here, there is information arbitrage. The information flow is not just limited to Silicon Valley, and, therefore, if your firm is set up to gain the benefits of the information and to share those resources across your entrepreneurs and your deal making, even if you do not do a deal overseas, the fact is that you may have gotten some information there that helped you make a better investment in the US.

Tina Ju of Kleiner Perkins Caulfield & Byers China:

I would agree. It is not an experiment. I guess as an asset class, we have always believed that venture capital is about exception, not about norm. We can speak for our own returns. Our first fund made 15 investments. We have already returned more than three times cash-on-cash return.

For our second fund, it is too early to tell. It has been two years since our first investment, but it is fully invested. We just had our first exit. We have six more IPOs/M&As in the pipeline.

The third fund is with Kleiner Perkins and still in the beginning stage, although we are investing. I do think that if you stay disciplined, there are great opportunities in China. I want to correct my earlier statement. I am not saying that a Silicon Valley will be created in China the way Americans define Silicon Valley, but I think being in China is an opportunity of a lifetime. There are great investment opportunities in China, but not in the same defined way as Silicon Valley.

Q2: What do you tell your limited partners about the foreign currency risk, assuming that many of them are dollar-based and one of these days, the dollar might rise again? Do you think about doing any kind of hedging to address some of these issues as well?

Sumir Chadha of Sequoia Capital India:

Our company is betting on domestic growth and so has rupee-denominated revenues and profits. We find that we are actually benefiting, because the rupee has been strengthening roughly 10% over the last 12 months.

We have several exporters in our portfolio that are doing hedging, so they are locking in their rupee-dollar exchange rate usually for the next 12 to 24 months. At the fund level, we have not done it, even though our LPs are dollar investors by and large and our investments are in rupees, but that is definitely a risk.

Moderator:

This must be an issue in Europe as well right now?

Neil Rimer:

Yes, to some extent. We raise our funds in Euros and most of our investments are Euro-based or Euro-linked.

Moderator:

You have less of a problem there.



Neil Rimer:

Yes. Historically, we have taken a view that the other risks we are taking are a lot greater than the currency risk between the dollar and the Euro. I expect it to revert to that kind of situation at some point.

Q3: Sumir, I am a little put off by your pessimism about India. In our fund, although the timing was superb in 1994, our limited partners made 16 times their money in India in six years. I don't quite get why you are so pessimistic, because it seems to me things are really taking off in India.

Sumir Chadha:

I think the shift today is that the opportunity is definitely much greater, but if the opportunity is five times, the amount of capital that is coming is 10 times. So when you do the balancing between the amount of capital and the opportunity, we see dramatic overheating: Internet, wireless, software, sectors that traditionally have been the mainstream of venture here in the US. I am not negative on the economy of the country, but I am negative in terms of returns, because the capital has grown too fast.

Q4: Another question for Tina and Sumir, both of whom were talking about competition. We heard about the importance of being early. Given the rise in costs and salaries in both China and India and the extension of supply chains for both components and for people, what level of activity are either of you seeing in the countries outside of your home country? Are you focusing on other areas in Southeast Asia or elsewhere in Asia?

Tina Ju of Kleiner Perkins Caulfield & Byers China:

We have been approached by other VC firms to look at investment opportunities, particularly in Japan, Korea, and Southeast Asia, but so far we have refrained. We are very focused on China. We think there are already a lot of different types of investment opportunities in China, so that we do not even have enough resources to evaluate these different types of opportunities.

Q5 (Moderator): Andy, sometimes you guys are the least constrained in terms of being able to go anywhere and think anything. Have you looked increasingly at less traditional markets that have not had venture capital as a major activity area?

Andy Goldfarb of Globespan Capital Partners:

We think that having a lot of strategic partnerships gives us a much greater network than we would have just with the individual deal-doers and it gives us greater access to information. So, as we approach markets, we have grown a multi-step approach of doing strategic partnerships and doing business development for our US portfolio companies, so value and information are being exchanged. That is the foundation on which we do investing—last as opposed to first.

Moderator:

So, you will not just go and do a one-off in Vietnam, when you have not done anything beforehand?

Andy:

It is the parachute analogy—we think that it's important to have ground forces as well as air cover when we're sending our people out.



Q6: Neil, I met with one of your portfolio companies recently, Martin Mikos from MySQL. Martin has 400 employees, I think, and they did a census of the employees and discovered they lived near 63 different airports and also reflected some notion of out-sourcing and virtual company building. Skype had 125 employees from 23 countries, with a development team in Estonia. How do you think about these global startup companies with different kinds of connections and how do you discover the right way to find them and nurture them when they are so global to begin with?

Neil Rimer of Index Ventures:

I think it took us a while to figure out. It certainly goes against conventional wisdom that you cannot work from home, let alone a separate country. We came to the realization that we would either apply these conventional rules of thumb and pass on things where, if things go right, the upside was large enough that we would never forgive ourselves for missing that opportunity. Or we could swallow hard and figure out a way of doing it and kind of trust the instincts of the entrepreneurs.

Q7: Andy, what did you mean about strategic partnerships as a way to get to build relationships in countries other than those in which you have offices? Are these side-by-side funds, where they can invest in some parallel fund to you, or do you have some other formal consulting or other relationship?

Andy Goldfarb of Globespan Capital Partners:

For us, in the markets where we are active, we like to have partnerships that range from strategic investment in our fund for business development, for information sharing at a variety of levels, and then within each company that we work with. Then you want to have multiple points of contact within each organization. For us, having more relationships in the market gives us more information that we can use to make better investment decisions, both in that market and in other markets in the US.



Panel III: How Is the Opportunity Set Changing?

Overview

The VC industry bets substantial amounts of its own and others' money on the future. What does the future look like to some successful venture capitalists? In this discussion, the panelists and members of the audience discuss ideas and opportunities—for new products, new services, even new business models. Among the major topics discussed:

- [New ideas that will drive new opportunities](#)
- [Industrial dinosaurs and how to kill them](#)
- [Innovating the business model to kill the dinosaurs](#)
- [Some places to put money now](#)
- [Does the VC model need innovating?](#)

Panel:

Dan Levitan, *Co-founder, Maveron*
 Terry McGuire, *Co-founder, Polaris Venture Partners*
 Ray Rothrock, *Managing General Partner, Venrock*
 Mark Stevens, *General Partner, Sequoia Capital*
 Moderator: Felda Hardyman, *Professor of Management Practice,*
 Harvard Business School

Moderator:

This panel will talk about what are the next opportunities in venture capital. All you really have to think about here is, "What really drives our business over the long run?" Part of this discussion will talk about, "Where can we innovate and where the innovation is going to be in the future?"

So it turns out that notion of looking ahead and being able to think about it is absolutely critical to this business. I am going to try to manage the discussion between the panelists to start coming up with some ideas. These ideas will come from an interesting group of separate silos: Dan Levitan is in consumer investing; Terry McGuire is primarily in medical investments; Ray Rothrock was actually a nuclear engineer; Mark Stevens is from a semiconductor background.

And most of you remember the case method, I hope, because as soon as we come up with an idea, I want to vet it with this group.

What is an idea that might be worth thinking about among you?

New Ideas that will drive new opportunities?

TERRY MCGUIRE:

One of the things that strikes me is that consumers are demanding access to health-care information. Right now, we all know that healthcare costs are skyrocketing; they already represent about 16% or 17% of the economy. They cannot go on forever. So, one of the questions that we could explore is how does technology empower patients to have more information about themselves and at the same time persuade providers to do a better job of monitoring patients outside of the critical setting.



Another last bit of intrigue here is that recently it has been announced that it is now possible for consumers to gather genetic information about themselves through a \$1,000 test. So, I guess the question is, if people are hungry for information about themselves, if they are trying to manage their disease, and if it is consumer facing, then what are the opportunities on that set?

MODERATOR:

Dan, do you think consumers want to know information about themselves in that way? How would you start a company around that?

DAN LEVITAN:

I absolutely think that there is a subsection of consumers that want to know this information. However, it is a mistake to think about consumers as a broad group. But I think that with Terry's company, 23 and Me, and Navigenics, this will be the beginning of an era of people who have a discretionary income who are going to be learning much more about their health than they ever have before.

MODERATOR:

The idea that we are going to start coming up with here is that there is something about consumer-driven healthcare and there is a whole lot more information that we can give the consumer. So, there should be some businesses that come out of that.

DAN LEVITAN:

This reminds me of a discussion I had around my partnership table in 2000 when we were smart enough to turn down Mark Vadon on Blue Nile. We thought, who is going to buy diamonds over the Internet? Today, he sells \$350 million worth of diamonds a year over the Internet. The concept of creating a transaction around trust and confidence that Blue Nile has done in multi-thousand dollar diamonds was unfathomable. So, I would posit that, in many ways, some of this consumer healthcare stuff in 2008 is where the Web was in 2000.

MODERATOR:

That is a good point: "Look, when it is available, the world changes." We don't know what consumers will do or not do. They may educate themselves.

RAY ROTHROCK:

There was a great deal in 1998–1999 where we invested in LifeMasters and refused to invest in Dr. Koop. And the thing is, it has continued since then.

MODERATOR:

Why did those not do so well? Is it because there just was not enough there there? I mean, one of the new things that Terry brought up is that he has a company that you can call up on the telephone, you lift the receiver and they tell you what your makeup is... something like that. It sounds pretty good. So, this is different. This is not just information.

**RAY ROTHROCK:**

I think this has been a classic \$0 billion industry for a while and eventually it will be a business, but the question is, “When?” That is the challenge.

TERRY MCGUIRE:

The only other thing I will say is the physicians that I have talked to are well aware that every day, patients walk in armed with more and more information. Ten years ago, most of the patients said, if my doctor says it is right, then it is right. Today, that is just not good enough. The other thing that patients are looking for is not just cures, they are looking for prevention. So, one could argue that a genetic profile does not tell you whether you are diabetic, but it may suggest whether you have a predisposition for diabetes. So, this information is more of preventative information—and that is why I think times have changed since Dr. Koop.

Session Quote

It is about identifying the dinosaurs in the market and what are the up-and-coming species in that market.

– Mark Stevens, General Partner,
Sequoia Capital

MODERATOR:

Let me ask you a bigger question. Ray, when you talk to your partners and you start talking about going into a whole new area, do you start talking about the market size right away?

RAY ROTHROCK:

Yes. Because you have to convince them that it is big enough to be interesting. A law of large numbers can cover a lot of sins along the way.

MODERATOR:

My point in asking this question is that I really want to push Mark. This is all about the market.

MARK STEVENS:

Well, it is about the market and the market size, but more importantly it is about the transitions that are happening in that market. It is about identifying the dinosaurs in the market and who are the up-and-coming species in that market. So, you obviously need a large market; you need a high-growth market. But more important, how do you take advantage of the transitions? I think everybody likes to invest in companies and entrepreneurs who have that foresight to see those transitions that are over the horizon. Therefore, it is market size coupled with the transitions that are happening in the marketplace.

MODERATOR:

I am with you on transitions. The question is, on these opportunities we are talking about, when we are looking way down the road, is it more the dynamics of the market or is it more the size of the market?



Let's pick some dinosaurs that this audience can kill in the next 10 years.

Strategies for Killing Dinosaurs

MARK STEVENS:

I think one set of dinosaurs are classical carriers, especially voice carriers like Verizon—not tomorrow but in 10 years. I think organizations, like Verizon, have been a tremendous impediment to innovation in the whole mobile ecosystem.

MODERATOR:

So, what is keeping them alive, besides billions of revenue? How can we attack them?

RAY ROTHROCK:

That is a two-part problem, because it takes two things to make it work. There are the carriers and there are the handset manufacturers, You have to talk on something and you have to get the waves out. I think the carriers are the dinosaurs and I think handsets are a way to crack it because it is an open system.

MODERATOR:

So the question is, this isn't going to get us into the infrastructure problem where we just recently saw a startup raise \$128 million to get some licenses but couldn't raise the rest of the money, right? So, you are not proposing replacing carriers with different kinds of carriers. You are saying you are going to attack them from below with open systems. Is this a good idea? Or is this an idea that we have already seen? Haven't we already done this with Skype? Haven't we done this with VoIP? Is this a good idea or a bad idea to put resources into?

AUDIENCE:

My concern is that people want ubiquity and quality. And that means infrastructure.

MODERATOR:

This is a classic venture problem, right? We spot the dinosaur, but we do not know where the soft underbelly is on this thing. How do you get at this thing?

RAY ROTHROCK:

Wasn't it Clayton Christensen of Harvard who wrote the book about disruptive technologies? His whole career has been about this: coming in from the bottom, starting your way up. We have been in plenty of companies where somebody came from behind, underneath us and just took us out.

MODERATOR:

So, how are you going to make this idea? How are we as an industry going to kill Verizon in 10 years? That is a worthwhile goal. You are saying disruptive technology.



We have had a lot of disruptive technology in the last 10 years.

RAY ROTHROCK:

And it takes someone like Google and the WiFi phone and all of the things that they are working on. No one would have thought that. Maybe they did, but no one would have thought a long time ago that a company like Google would attack the phone business.

MODERATOR:

Is Google a competitor to the venture industry?

RAY ROTHROCK:

Probably in a small way. They are buying up entrepreneurs. That makes them competitive.

MODERATOR:

They are buying entrepreneurs but they are also creating new markets here. Is there a market around for this? I'm looking for some consumer help. Is there an opening here to kill Verizon, beginning now, within 10 years? Who would you have to sell to do that? Or is this just a bad idea to be working on? Is anybody here willing to assign two partners and an associate to come up with a plan to kill Verizon within 10 years? Or is it just jousting at windmills?

AUDIENCE:

Talk to the FCC.

MODERATOR:

The FCC. You could get at them with regulatory. Is it logical or not? No. But this is a good thing. You have to find something, a technology, that skirts the regulations. Right? In a way Skype did that, right?

So, it is picking off this regulated idea. Maybe the panel can help us with this. Part of this idea might be that they are protected by regulated spectrum. Also, they are protected by a lot of copper in the ground, right? So let's go after WiFi and some of the other unregulated spectrum.

MODERATOR:

Let us pick another dinosaur company to go after. What companies will not exist in 10 years? Why don't you give the Red Bull example?

DAN LEVITAN:

Okay. So Red Bull is a company that came from nowhere. I think their consumption is 4.2 drinks per capita per year and that is a \$2 billion business from nothing in an energy drink category. That is kind of a classic example: then in come the guys who have to get into the sector to either build it or compete with it.



MODERATOR:

So, here's an idea: go after everyday branded consumers, because we can now reach consumers in such targeted ways and we can piggyback on other people's distribution. Is this a good idea?

AUDIENCE:

It is more about the elephants than about the venture capital thing. Verizon and Coke are basically marketing companies.

MODERATOR:

Verizon is nothing more than a marketing company that happens to have some copper in the ground. So, one of the reasons why this is a good idea is because they have a readymade market to sell your company.

So, are you saying it is not a good idea to be talking about Coke and Pepsi as a potential—taking advantage of their ability to reach different consumer segments and going after them with a lot of different drinks and then using them as the buyer of last resort?

Is this a good idea to think about consumer products? Coke and Pepsi are the example, and we now go after them because we can. Because we now have the Internet, because we now can make un-dense markets dense. Is this something that we should be thinking about as venture capitalists?

So you want to talk about cable as maybe being a dinosaur. Do you believe it's a dinosaur?

MARK STEVENS:

It could be, if you believe that wireless technologies will obviate the need for copper or co-ax in your home or office.

Terry McGuire Actually I agree with what Mark has said: that ultimately wireless at accelerated speeds will take a lot of the capability that we are finding now in cable.

MODERATOR:

So, just translating products to wireless is a big opportunity?

RAY ROTHROCK:

Cable does not necessarily mean copper. Cable could be the wireless guy. It could be satellite issues, that is, the notion of whatever delivers the information to your

Session Quote

Business model innovation is going to be an awesome opportunity for venture capitalists.

-Felda Hardyman, Professor of Management Practice, HBS



home.

MODERATOR:

We were talking about this 10 years ago—those endless partnership meetings where you talked about the last mile trying to figure out how much it would cost. And we have invested in a gaggle of things that help it. And then one day we wake up and it is already here and we did not notice it. So the question is, what is beyond the last mile into the home?

RAY ROTHROCK:

Distribution within the home.

AUDIENCE:

We need to separate markets from technology.

MODERATOR:

I am so glad you brought that up. You are saying, let us talk about business model innovation too. Just to keep everybody on the same page. Business model innovation is going to be an awesome opportunity for venture capitalists. Terry, is this business model innovation a really big opportunity for venture capitalists?

TERRY MCGUIRE:

Yes, if you look at a number of industries that have launched programs because the business model was appropriate. And I think the cellular industry initially, looking at paging, was essentially launched by the fact that they were not charging, they were capturing the service as opposed to the device itself. And I think that model could extend to things including healthcare.

MODERATOR:

What model will extend to healthcare?

TERRY MCGUIRE:

The idea that, as with healthcare right now, you pay for a service, a device, upfront at full cost; they provide service for years, but you pay for it today. The model you shift to essentially says maybe you pay for that service's economic life through a service contract. It is a model that could change parts of the device industry.
Innovating The Business Model

MARK STEVENS:

I think business model innovation is alive and well and it has been alive and well for a long time. I remember back 20 years ago here in the Valley there was a mantra, "Real men have fabs." You want to launch a semiconductor company and along came the so-called fabulous model. Now, it is truly a unique new model that has been copied and emulated and it has brought tremendous wealth to lots of folks.



10 years ago, who would have thought that when we invested in Yahoo at Sequoia, we looked at David Filo and Jerry Yang's product and thought, "Oh, this is interesting. It is a table of contents for web sites."

But it was not until later, as they developed a company, that this whole notion of advertising on the web became a business model. And now it is a multibillion dollar business model. So I think we are going to continue to see business model innovation embedded in the minds of entrepreneurs and the minds of management teams that people in this room finance.

MODERATOR:

But your example brings up a great question. Business model innovation to a large extent is experimentation. We are not quite sure where we are headed, we are just changing it. By the way, it does bring up the question for a firm that really looks at the market first: what were you thinking of in 1995, when Yahoo had no revenue and no market to measure?

MARK STEVENS:

In that case we viewed the market as, "Hey, this is a product or a service that a lot of people would want to use— a potentially big market. And we knew the number of websites was exploding and these people had a way to catalogue and track that. Then the question became, "Okay, how do you pay?" How do we extract dollars out of each of those users' wallets to make it a success?"

MODERATOR:

That is not, by the way, a bad model to think about. If we are thinking about business model innovation here, it is going to be very difficult up front to see it all laid out. I want to hear somebody in this room tell me an industry that is right for business model innovation right now.

AUDIENCE:

The direct sales model.

MODERATOR:

You mean anybody who is selling anything with direct salesmen, which by the way is a lot of different industries. So we should be looking at companies that traditionally sell by direct sales with the notion that somehow we are going to get it to the market differently.

So, now we are back to last year's really good idea, which was software on demand,

Session Quote

How many people have seen the Amazon Kindle, a very interesting application where you basically have this little e-book and you can download daily any newspaper, magazine or book. A friend of mine had it and I think it addresses a lot of the problems of why people are not buying a particular newspaper today.

- Dan Levitan, Co-founder, Maveron



right? Was that the kind of thing you were thinking of?

AUDIENCE:

More than that. The model of direct sales has been eroding for some time. There are personalized applets...

MODERATOR:

So products themselves are changing, too; this is also a product revolution as well as a way of getting to the market.

So, an example is that you download a piece of software and you customize it, where in the past you would have had a lot of setup cost. Now, you're selling a module at a time.

So, how about that? In the direct market, I am thinking of the pharma guys. I do not know how much pharmaceuticals you guys do, but how are we going to innovate around the detail man?

Session Quote

One of the problems with our industry is, we get all the good ideas. Unfortunately, we often get them 20 years too soon.

-Felda Hardyman, Professor of Management Practice, HBS

TERRY MCGUIRE:

I think it is a huge challenge for the pharmaceutical industry right now. And they clearly have to get the message out, they have to get their products out. Although I think part of the issue is that the pharmaceutical industry has to have a delivery mechanism: the direct salesperson also delivers samples. The distribution system entices physicians to use the drugs. So, you can't simply change the direct sales model first.

MODERATOR:

Could there be a business that replaces the pharmaceutical companies' direct sales force? Is there some other way to get to the doctors? To solve both the physical delivery problem and the information problem?

TERRY MCGUIRE:

Yes. The other issue is the actual sales process itself, which wants to get the very limited mindshare of the physician. If they are given seven minutes with the physician, they are not prepared to sell too many products.

MODERATOR:

Could you start a pharmaceutical company by focusing not on the generate-the-molecule end of it the way we have, but instead on the business model of the pharmaceutical company itself?



TERRY MCGUIRE:

You can argue that the generics industry itself is based on the idea that the writing patterns of the physicians have been well established. They know what the drugs are and now they can get them for less.

MODERATOR:

So, we are talking about business model innovation as part of the way forward. Direct sales is an example. Pharmaceuticals may be an example. The advertising world is upside down. Newspapers are dead. How do we make money from the death of the advertising dinosaurs—the newspapers, the broadcast networks—all that sort of thing?

MARK STEVENS:

I do not think newspapers, radio, all these other traditional means of communication, are going to die. I mean, TV did not kill radio and cable did not kill broadcast TV. But their growth rates are attenuating or declining. And we are still going to buy newspapers 10 years from now, but not as many. The true growth, and the transitions that I talked about earlier, are coming in the online advertising space and the online media space.

MARK STEVENS:

Sure. Ten years from now, or 50 years from now, maybe radio and newspapers are dead, because all the people who still buy them now are dead... but in a 10-year timeframe, I think these other traditional forms of media will still be around, but they will not be as profitable and there will not be as many of them.

DAN LEVITAN:

I agree that there will be a slow decline. But how many people have seen the Amazon Kindle, a very interesting application where you basically have this little e-book and you can download daily any newspaper, magazine or book. A friend of mine had it and I think it addresses a lot of the problems of why people are not buying a particular newspaper today. And I can imagine that as an example of all the existing best-of-class publications with a different delivery mechanism that is consumer friendly.

MODERATOR:

To go from Bob's, to Mark's, to this chain of thought, is there going to be a new kind of basic media that people walk around with? Something like the Kindle? Is that a new publishing opportunity? Should we be investing in publishing? In the modern version of Slate, the online magazine, which itself was way ahead of its time?

Session Quote

And talking about business model innovation, Apple has created a certain psychological contract with consumers... Because of consumers' belief in the brand, they have integrated this iPhone into their lives along with other Apple products. We talked about disrupting elephants by sheer might; this is a reverse of that.

– Dan Levitan, Co-founder, Maveron



One of the problems with our industry is, we get all the good ideas. Unfortunately, we often get them 20 years too soon. Is this maybe the time to be talking about edited, published media like Slate. Would you back that now?

DAN LEVITAN:

I think I probably would not, because the costs of creating a best-of-class content company feel too high to me. I like the concept of the Kindle or—how many of you have the iPhone? [*Show of hands of about 7%*] That is an interesting company. And talking about business model innovation, Apple has created a certain psychological contract with consumers. Obviously, not with this crowd largely, but... I think they have kind of “taken” and because of consumers’ belief in the brand, they have integrated this iPhone into their lives along with other Apple products. We talked about disrupting elephants by sheer might; this is a reverse of that.

MODERATOR:

That is a good point, but let’s talk about what opportunity that gives us. The device world scares us just because of the scale that is required to be relevant. Are we done investing in devices as an industry? Well, we are going to continue investing in semiconductor devices because it drives industry. That is another whole separate topic. Are there certain things that we always have to be investing in? Mark, are you telling your partners that we will always be in semiconductors?

MARK STEVENS:

I think we will invest in semiconductors or components that look like semi-conductors. If you believe that the world needs more computing power, more communications power, silicon-based components have been the source of that for 30 years and will continue to be at least for another 10 years. So, yes, I think you need to continue to invest in components if you are going to have better iPhones and better medical devices.

MODERATOR:

But our companies apparently are not going to make the better iPhones, it is going to be the bigger companies.

RAY ROTHROCK:

I think there is a great opportunity in devices, because all that it is about is just bringing personalized information to you. This medical device that you mentioned is all about getting it anywhere, anytime I want it, and also putting it back somewhere safe and secure. We are in the first out of nine innings. It has a long way to go.

MODERATOR:

It sounds like maybe the biggest thing that we have been talking about so far is this whole notion of information coming to the individual and information going out from the individual. There are going to be dozens and dozens of applications, hundreds, thousands of applications over the next 10 years that we all are going to feast on.



It looks like everybody is shaking their head—and that goes across the silos. Is that what we believe? That our industry for the next 10 years is going to be based on applications back and forth to the person?

AUDIENCE:

I do not agree. I think semiconductors and cellphones are just software in a different packet.

MODERATOR:

This goes back to the business model. You said the reason we stay away from investing in devices is because we have the inventory problem, supply chain problems, all of that, and maybe even a direct sales problem. By the way, the world may change on that. Supply chain and manufacturing technology may change dramatically and suddenly we will all be back in that business.

So, this is a good time to start switching this topic, because we have actually talked about this a long time. There are two ways of looking ahead? One is, what are the things you really want to invest in? And the other is, what is everybody going to avoid investing in, because history has shown that when you are willing to strike out a little to the side and nobody else is there, you have enough time to make it work.

... Now, it gets to storage. What sane venture firm today would do a startup in storage? And the answer is, maybe the most sane, if they are the only ones. But we are in the industry that also has learned how to use other people's money, right? The pharmaceutical guys live off of other people's money, right?

So what is your best single idea right now? When your next Harvard MBA hire comes into your firm and says, I want a project to work on, and you are their mentor, what project would you give them?

Session Quote

You may remember that a number of us tried to invest in materials in the 1980s and it was like being led into a valley and then the end was shut off and it was flooded. I mean, we all got killed in materials.

–Felda Hardyman, Professor of Management Practice, HBS

Some Places To Put Money Now

DAN LEVITON:

We invested—getting back to shoot where they are not—in a pet health insurance company. In the UK, 20% of all pets are insured. There are 90 million pets in the US; 600,000 of them are insured. So, we put together a deal where we brought an insurance company and ourselves together to find an insurance shell, and we took the fastest-growing pet health insurance company in Canada, domiciled it in Seattle, and are going to launch in the next six months in the US.



MODERATOR:

So, there is an example of actually taking an idea that was somewhere else and bringing it here.

DAN LEVITAN:

In our minds, riding the macro theme that veterinary services have grown at twice the rate of the GDP over the last 25 years.

TERRY MCGUIRE:

I am attracted to what I call smart implantable devices that have the ability to deliver therapy, monitor, and communicate. I think we are going to push patients to their homes and they are going to live longer with chronic disease. So, since we have to keep them healthy until they have episodes, these devices will be used to communicate to the patient and say, "You are in trouble, go see your physician."

MODERATOR:

Wow. This has amplifications all the way back through the chain, right? To the semiconductor guys, who need smaller, lower power, more specific. So what are you going to tell your mentee?

TERRY MCGUIRE:

Bluetooth centers hooked into your cellphone or something. You could connect that way, but I think the magic is not necessarily in the handset itself—it is in the device. It is hooked to you.

RAY ROTHROCK:

I think the automotive industry is in for trouble in 10 years, because gasoline will become very, very expensive and electricity will look better and better. And we will not know how to deal with that as a society, and cars will not run out of gas but they will run out of charge. I see being able to pull into your home at night and the car saying "I need to charge up!" and giving you lots of diagnostics, giving you preparation. I see a smart car that sort of takes care of itself.

MODERATOR:

So you are talking about infrastructure around a new car?

RAY ROTHROCK:

I mean around transportation, because we have done a lot on communication and medical and I think of transportation in the same category: there are \$20,000 electric cars that have \$20,000 battery packs. But when you buy a car, you do not pay for all the fuel up front; you do not pay for the gas tank separately. So, some innovation is going to be in how do you finance that? How do you service those things? What do you do with the materials? A whole industry will fall off the electric car innovation, which is a long trend but I think a steady positive trend.



MODERATOR:

How about you, Mark?

MARK STEVENS:

In an hour of talking and debating, we have not talked about energy or cleantech at all. I am personally very skeptical about a lot of the dollars going into cleantech right now. But, having said that, I think if I were going to deploy a new Harvard MBA in our shop, I would have that person go look at other investment opportunities in energy demand management, making energy use more efficient, whether it is software or hardware or other kinds of business models. But I do not think we would go out and finance the next solar cell company. This room has partly financed a hundred of them so far.

MODERATOR:

How many people in this room have financed a solar cell company?

MARK STEVENS:

Okay, 20 or 30 in this room. Energy is a \$6 trillion industry, it dwarfs all other industries. The whole idea of managing energy use, the demand side as well as the supply side: There could be some interesting opportunities that are not as capital-intensive as putting up a \$200 million ethanol plant or a \$100 million solar cell plant.

MODERATOR:

Let's talk a little about green tech. The example you gave is materials related, you may remember that a number of us tried to invest in materials in the 1980s and it was like being led into a valley and then the end was shut off and it was flooded. I mean, we all got killed in materials.

Is that the downfall of cleantech? How many people here have a cleantech practice right now? [Show of hands] I would say half the room has one right now. How do you handle it?? You always were talking about materials in the semiconductor world. Is materials the Achilles' heel of these cleantech practices?

MARK STEVENS:

I do not know if it is the Achilles' heel. You look at solar cleantech and it is all solar cells, which are really semiconductors, right? The materials, biofuels, that is chemistry. I tell my partners that if we are going to do a biofuels deal, we had better whip out our chemistry books. So I do not think the materials are the issue. You cannot get your hands around..... does this molecule work? Does this enzyme work? Is the material in the solar cell going to work?

It is what we were talking about earlier. It is about the business models. At the end of the day most cleantech investments have a competitor: fossil fuels. Specifically, if it is transportation-based, you are competing against the price of oil and the whole oil ecosystem. If it is electricity generation, you are competing against nuclear or coal. I think you have to look at the business model; who are you competing against? Why is it economically compelling?



I think the materials part of cleantech or new energy will get figured out. A lot of it will be trial and error, but it will get figured out. I am more skeptical about who you are going up against: are the oil companies and the auto companies and all this massive infrastructure really going to be dinosaurs in 10 years? Because that is the timeframe that we as venture capitalists have to look at. Twenty or 50 years from now I think they will all be dinosaurs, but in the 10-year timeframe in front of us, by the time you figure out the chemistry of the materials, you are four, five years into it in a lot of cases.

The venture industry may be in for a rude awakening in investing in cleantech, because we are so used to investing a few million dollars in a software company or a chip company or some medical device company, and within a year or two, you know if the dogs are eating the dog food.

TERRY MCGUIRE:

It is the biotech model, of course. In biotech, we invest in companies where we know there will be decades before we are even going to see revenues, let alone approval and whether they work or not. So I am going to instruct that the energy cleantech space is really more like a biotech model. And my biggest concern is, in biotech at least we have the Mercks and the Pfizers of the world that all recognize that they are going to help launch our young. The real question is, do the energy guys have the same mentality? Do they look at the distribution capabilities and say, hey, we need to get these guys hundreds of million of dollars to get launched? A model has been established that has been relatively profitable for some of us, which is the biotech model.

Does the VC Business Model Need to be Changed?

RAY ROTHROCK:

I think a lot of LPs have to get their minds around a timeframe not of a 10-year partnership model, but more like 15-years or 17-years.

MODERATOR:

Now there is a business model innovation.

RAY ROTHROCK:

And it is not that IRRs will necessarily get you, although the energy business is massive, but you are going to get cash on cash, because if it works, it will be deployed globally in a relatively modest amount of time. So, I think you can have a big return, but you just have to be patient to get there.

MODERATOR:

We are now investing on such a global basis, we are no longer innovating in little corners: is our business model broken, and should we be asking for 15-year money rather than 10-year money?



RAY ROTHROCK:

For example, if you are going to do biofuels in the United States, I would do sugar cane in Brazil, because it has four times the energy density of corn. So we have to go overseas, we have to get into that regulatory environment. We have to do all those things, and it is going to take time.

MODERATOR:

Let me here ask a limited partner: are you willing to extend that partnership agreement from 10 to 15 years? Should we innovate on our business model?

AUDIENCE:

I think that the venture business model has been pretty rigid for a long time

AUDIENCE:

I just love the idea that the venture capitalism industry sets up a barrier to exit.

MODERATOR:

That is exactly right! So, is this really a serious business model innovation that our industry needs? Because some of these things that we have talked about are going to be slow-uptake. Are we equipped to actually face this brave new world?

... Are you picking up on Terry's pharmaceutical model? You are saying, "Look, you still should be able to at least prove the model, even if the drug is not in the market." So you should actually be able to get far enough. We may have a 20-year vision, but we have 10 years to prove it. Paul, do you think the model is absolutely wrong?

AUDIENCE:

The venture industry was built for IT and communications. It is a special case, just a little piece of the global economy. It is not going to work.

MODERATOR:

So, the next big thing might be innovating our own industry. Paul made a point here, saying, "Look, this is an industry that was really built around Silicon Valley and we can get it done in five years, \$5, \$10 million." We have accepted this model and we innovate around it. But is our basic model not good enough, not big enough, not broad enough for all of these new opportunities we are talking about? Do we have to go back to our limited partners in about 10 or 15 years and say, "We have to innovate on our own business model, we need more time, we need different ways of compensation, etc." Is that the last, next big thing that we have here? Can we get along with the model we have?

AUDIENCE:

I should say, we are venture capitalists, not researchers, we have to draw the line.



MODERATOR:

So it is a matter of discipline. What do you guys think?

DAN LEVITAN:

It seems to me that people typically innovate when they have to. And we have been fortunate that we have not had to. I agree that after 10 years, it seems to me you should prove something. But I think the question is not, have we proved it, but what the real runway is for the acceleration of the company's value creation if you have a 10- or a 13-year fund? It just seems to me obvious that if we all had much more of our financial incentives 100% aligned—and you are never going to be 100%.

MODERATOR:

So maybe the answer is something as simple as having, one-, two-, three-year extensions on your fund. Or really special extensions. Either that or maybe for LPs, we're only willing to take private equities, you know what I mean? That would be a nice distribution. But something like that might be some sort of agreement between us. Our LPs are going to be more partners than ever before in this world.



Panel IV : The Future of Venture Capital

Overview

What do venture capitalists foresee as the significant upcoming strategic developments in their industry? What problems do they anticipate? The participants in this Panel Discussion raise issues of reorganization, diversification, new sites for operation and investment, and the problems raised by the US economy and policy.

Among the major points of discussion:

- The importance of right-hand tail companies!
- Distribution of returns and the tensions between limited and general partners
- Human capital: where is it coming from now—and where is it going?
- Changing the model for venture capital: a good idea?
- Fighting the “headwinds” for venture capital expansion

Panel

Jim Breyer, *General Partner*, Accel Partners

Peter Lawrence, *Managing Partner*, FLAG Capital Management

Art Marks, *Co-founder*, Valhalla Partners

Peter Wendell, *Founder & Managing Director*, Sierra Ventures

Moderator: Bill Sahlman, *Professor and Senior Associate Dean for External Relations*, Harvard Business School

One thing we have seen in the global economy in recent years is the importance of what I call right-hand tail companies—so we look at Google, eBay, MySpace or YouTube. What do you think about finding right-hand tail companies? Do you look in normal places or do you look at serial entrepreneurs? Do you try to find 25-year olds in the computer labs at Stanford? Do you try to find the Mitch Kapors of the world who taught transcendental meditation?

JIM BREYER OF ACCEL PARTNERS:

In terms of the best entrepreneurs, we are scouring the world. We now have three or four entrepreneurs under age 25 in our portfolio; they are very similar. They are iconoclasts. They have a fervent view that they are going to change the world. In many cases, I would call them product geniuses, but they are not necessarily the ones who invent the product. They just have that intuitive ability to identify what might be a simple yet deeply compelling and engaging consumer experience.

We go into these deals knowing that the mortality rate might be very high, but we also know the capital intensity is likely to be very low, so we take our chances. These individuals and teams tend to believe that they can do almost anything, so that we find ourselves being very conservative in terms of always playing devil’s advocate. We are seeing these individuals in London, in Beijing, in Silicon Valley, and in Cambridge. Many of them fit the mold by having dropped out of some school, whether it is undergrad, business school, or high school. So, we pulled all that together and now we have a very clear pattern of what we are looking for.

PETER WENDELL OF SIERRA VENTURES:

The first thing is that in a variety of sections, you can build companies a lot cheaper now than you used to. Therefore, we ought to be able to scale back the capital, get



some visibility on traction results for not much money, and use that to make a reasonably quick decision in six months to 12 months at most, whether or not we are going forward.

Second, geographically, we have always had a large amount of our money invested domestically in the US outside Silicon Valley. By now, over half of it is not within 100 miles of our office, and a substantial amount is in other areas of the country. That served us well. In the last year, we have had three or four big liquidity events and none of them have been in the Bay Area. We are focused on the ability to be responsive to smaller things, to experiment. We are focused on being responsive to wacky people with wacky ideas walking in, who are going to be huge, and to being much more geographically open to places where a lot of other people are not.

ART MARKS OF VALHALLA PARTNERS:

We think of ourselves as being in a golf game. In our core discipline, we try to hit a good first shot and see what we can do with that, and have a good second and third shot plan, and sort of enjoy compound growth and adjacent markets as the core of what we do. Interestingly, we did the how-to at the beginning of last year and we carved 10% of the fund out for 1- to 2-million dollar investments in disruptive technologies with passionate leaders. We have two lined up; that's actually been harder to do than we expected, changing the processes, changing the deal flow, but also looking for a different flavor. But our core is to see simple ways to get meaningful value everywhere is playing. That's how we're playing the game.

MODERATOR:

Peter, how do you look at this whole issue of the nature of the distribution of returns? How do you look at strategies where people are trying to reorganize themselves, adapt to a changing world, the declining costs of entry for some, particularly consumer Internet? Can you give examples?

PETER LAWRENCE OF FLAG CAPITAL MANAGEMENT:

There is one additional element of overlay: there is always some tension between limited partners and general partners. But often there has been more, I would say, as the model has evolved in recent years and in regard to terms and negotiations, the pendulum has swung very much in the direction of the general partners' side of things. As funds have increased in size, the risk is that the financial incentives are beginning to diverge, or have diverged, and this causes us to think a lot about the true, internal objectives of the firms that we are backing.

When it comes to this issue of business models for the fund, we are looking for different types of managers to invest with. But we are also very interested to see that the general partner teams are on point or on strategy with respect to what they told us they might do.

Session Quote

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– Jim Breyer, General Partner,
Accel Partners



In terms of the kind of people we are looking to back, or what kind of strategy we intend to pursue, one example is in Israel. Every fund in Israel today will tell you that they have an incredibly active seed program. The way to win deal flow is to get to the entrepreneurs as early as they can. They have a problem there, from the venture capital perspective: there is a very active angel community. If they do not get to the deal early, they are likely to lose the deal, particularly because models now are more capital-efficient than before.

But those are the kinds of things that can get overdone. It is important that we understand the strategy. We hope to see that the general partners have structured themselves to take advantage of the opportunity that they do see. For us, we do not invest directly. Rather, we try to understand the business model pursued by the general partners as much as they are trying to understand the business model of the entrepreneurs.

MODERATOR:

Peter, the LP community is not well represented here and I have heard people speak disparagingly of it. One issue is that they are asking their venture firms to use strategy X in country A, while asking them not to change what they are doing. This happens when a shift in the opportunity set has occurred, both in terms of the geographical locus of opportunity and of the sectors one should invest in. Is the LP community creating a trap for themselves?

PETER LAWRENCE OF FLAG CAPITAL MANAGEMENT:

I think that it goes back to the issue of why you are changing your strategy. Does it have to do with something in all of our interest? We truly are partners, so it is incumbent on the limited partners to recognize their role as a partner, as much as it is incumbent upon a general partner to understand what limited partners are. But I think that it makes sense in the life of a fund to morph a strategy if it is in all of our interests. It is not in our interest if one is compelled by something other than great returns.

JIM BREYER OF ACCEL PARTNERS:

About 75% of what we do will be on strategy—whether on the early stage, lead, or co-lead in the industries that we think we know something about. But we are very explicit that 25% or 30% of the dollars in each fund will be off-strategy. Those tend to be the most controversial deals that we will typically do. In some cases, they turn out to be our best deals, but a significant portion of partner energy goes into trying to be off-strategy. We try to marry what is a consistent long-term, focused, HBS-like strategy in terms of the core business. We believe in being off-strategy and trying to find pockets where competition is much less, where there is just a differential insight. That is a very important part of how we have tried to build a firm both here in the US as well as in China and in London.

PETER WENDELL OF SIERRA VENTURES:

The other part of that is since we have a portfolio, there is room for some deviation, and as you do in your memo, and as I am sure we all do in our offering memos for Sierra 9, we say “Hey, here’s what we expect to do with the vast majority of the money.” But some of the proceeds will be used in some ways we cannot envision now.



In one initiative I spoke of with regard to a different entry-level program, we say we are going to have two or three fewer deals in the portfolio; we are going to take that capital and identify it. But you are in an industry where firstly, you have a portfolio to work with so you can have some experimentation, and secondly, you are on about a three-year capital cycle so you are facing your makers every three years to have a discussion of these things. We have more ability to morph and move as the set of opportunities morphs and moves.

MODERATOR:

Jim, how did setting up operations in London and China affect how you think about the business? How do you manage that network?

JIM BREYER OF ACCEL PARTNERS:

They are easier. We do not believe that it is easier because these markets are global. We believe that aspects of the venture capital business and what we've learned from the mistakes that we have made over the years that can be applied in selected ways, whether in Europe or in the Chinese consumer Internet market. Typically, we will then get very systematic on how we want to develop the business.

Our co-founder in London was actually a business school section mate of mine. In China, we spent a year trying to woo the IDG China team and formed a joint partnership there. We try to come to each geography with a different model. There is something to be learned in our US investing from each of these opportunities. But when all is said and done, the success of our China venture capital activities will very much depend on whether we are picking good deals. Are we money-makers in China? In Silicon Valley, we are. Some of our expertise may be improved because we understand Korean gaming models. But when all is said and done, we ask "Are we smart? Are we hustling? Are we identifying the very best entrepreneurs?" The same would be true for London. We try to not impose too much overall structure and bureaucracy.

MODERATOR:

Peter, where would you put all of your personal money today?

PETER LAWRENCE OF FLAG CAPITAL MANAGEMENT:

We are pretty heavily invested in both private equity and venture. There is a reason why you want to be in both areas. So as far as venture is concerned, the question is: which global sector in the venture area?

We have done a fair amount of work around performance of the venture. But when

Session Quote

When you look broadly across the industry, it shows that the concentration of returns is just crazy; that right-hand tail is owned by a really small group of people. More than 50 percent came from just 30 firms. They raised about 9% of the capital and they returned about 60% of the capital. It is highly concentrated.

*- Peter Lawrence, Managing Partner,
FLAG Capital Management*



you look broadly across the industry, it shows that the concentration of returns is just crazy; that right-hand tail is owned by a really small group of people. More than 50 percent came from just 30 firms. They raised about 9% of the capital and they returned about 60% of the capital. It is highly concentrated.

We also included some life sciences funds in there. I have not been a fan of life sciences in my firm, but I realized there is movement in that direction. It is important, I think, to be diversified across some specialist types of firms. But that concentration forces us to be smaller, forces us to cut our risks there and thereby focus on the people who have been historic winners.

MODERATOR:

Let us assume that everyone here is a top 30 firm. They did not get 40% of the available returns. There are more returns out there. How do you think about building that kind of firm? How do you think about the industry and its attractiveness for you, your partners, your limited partners, and also the young people you have in your firms?

JIM BREYER OF ACCEL PARTNERS:

First of all, every five years or so, a couple of really interesting new firms get created. There are firms out there filled with HBS grads who are focused on applications services and hosted service software models, and the businesses are sufficiently defined that they are seeing deals that the rest of us often do not see. Every five years, a group of smart, tenacious people can carve out a geography-focused fund or an industry-focused fund. There are always ways to innovate and build what could very well be the persistent great firms.

I think franchises can be deeply overrated. It is a question of the energy of the partners. Some of the hallmark franchises—Greylock, Kleiner Perkins, Sequoia—have continuously innovated and added great people. We have co-invested with many people in the room, and it is very personal; the transaction is not so much firm to firm, so that as we think about generational transition, you want to create enough interest so that the partners in their 60s are as engaged to come to work as the emerging partners in their 20s. That might mean that in some cases, you let those partners in their 20s really run with the deal, even though the partners in their 60s are saying, “This is just like the semiconductor business of 1972 and we’re going to lose all our money.”

So there is always that fine balance; it is art, not science. But I would say that it is that constant people innovation and trying to get people who really love the business and who want to make a difference that leads to what might be considered long-term franchises.

Session Quote

In some cases, you let those partners in their 20s really run with the deal, even though the partners in their 60s are saying, “This is just like the semiconductor business of 1972 and we’re going to lose all our money.”

– Jim Breyer, General Partner,
of Accel Partners



PETER WENDELL OF SIERRA VENTURES:

Two of my worlds would be informative to your question. I teach at the Stanford Business School, and the students interested in coming into the venture capital field are among the very best students. Like many in their mid-20s, they are considering careers in venture capital. A lot of them are asking, "Should I be an entrepreneur first? Should I be in entrepreneur or should I be a venture capitalist?" You have these people on your doorstep three times a week as well. But the quality of at least that micro-universe, the quality of younger people interested in entering the industry today is at an all-time high. Really first rate.

Second, I have been for the last ten years one of the directors of the Princeton Endowment, and for the last six years, chair of that board. Princeton now is up to about \$17 billion in endowment and about \$2.8 billion of that is deployed in venture capital firms and private equity firms. We see a wide array of things, and I will tell you: the new entrants into this industry over the last five or six years have been good bets because it has not been simple, especially since the bubble burst, to hang your shingle out, start a venture firm and think that everyone is going to throw money at you. I think the entrants into our industry have been good. I do not see a lot of flashing red lights indicating the world is about to end.

Session Quote

Not one company in our portfolio is not outsourcing a significant amount of work somewhere. Argentina, East Europe, and India are all using that world network, even though they are really small.

– Art Marks, Co-founder, Valhalla Partners

ART MARKS OF VALHALLA PARTNERS:

We realized that we could not, on the first day, become something from scratch, and we restarted in the venture business 5 1/2 years ago with the objective of ending up as a top quartile or top decile firm. We feel as though we deal with one investment and one partner at a time. We spent a lot of time mentoring people. We tread in other sectors really well. We limit the number of investments to five or six in any partner, and we try to help the companies bring them along in the old, what I will call today the RDJ, Rock-Draper-Johnson, kind of firm. We have made improvements in that direction and in five or ten years, you will be able to tell whether it worked or not.

MODERATOR:

The issue of globalization and access to human capital is interesting. One problem we have in the US is that we have begun to make it increasingly hard for people to come to school here, to cross borders, and to get work visas. How critical a role does human capital play in your portfolio companies? What percentage of your entrepreneurs are not from the US?

ART MARKS OF VALHALLA PARTNERS:

At least a third. Not one company in our portfolio is not outsourcing a significant amount of work somewhere. Argentina, East Europe, and India are all using that world network, even though they are really small.

**MODERATOR:**

A Chinese university alumni network in Silicon Valley had 4,000 members and had an extraordinarily active meeting schedule. But now, they cannot get a quorum, because they all moved back to China. Now, we have reversed the flow partly because it is easier and we are somewhat inhospitable to new equivalents coming over here. What impact does that ultimately have? Does it just mean that you have to follow the human capital abroad?

PETER WENDELL OF SIERRA VENTURES:

Are those funders going to do well over there? We have 70 sophomore students. Last year, about 22 of them were from India. Of those 22, 15 are back there. Fifty years ago, when I was teaching, that never would have happened. First we would not have had that many, but of those that we had, a vast majority would have stayed here.

PROF. BILL SAHLMAN (MODERATOR) OF HARVARD BUSINESS SCHOOL:

I think that HBS people are perceiving opportunities to be greater in their home country than they are in the US, and so you have an immediate return to home countries.

PETER WENDELL OF SIERRA VENTURES:

Particularly the differential: you know, some kid gets a Harvard MBA or a Stanford MB, they go back to their country and they're big stuff. I mean, you know, they are going to compete for capital well in those environments; they are going to hire people well.

ART MARKS OF VALHALLA PARTNERS:

I will make a prediction, which will be very unpopular. Right now, many people are taking the venture model we all know and exporting it to China and Israel. What is going to happen in the future is that some of them are going to be really successful. Then they will ask, "Why are we shipping half of what we're making back to them? We're funding all those losers and money is going to follow the talent." They will say thank you, it was a great learning experience. When they can do it on their own, they do not need us anymore.

Session Quote

As you know, India has been a great outsourcing location, but wage inflation has been 15% to 25%. Turnover has been 25% to 30% per year; the rupee inflated 15% in 2006. Infrastructure cost—or should I say costs to offset the lack of infrastructure—are probably 30% of the operating budget and the outsourcers in India are starting to outsource to Vietnam, Sri Lanka, even China.

– Art Marks, Co-founder, Valhalla Partners

Audience Q & A

Q1: What is your perspective on South America, Argentina, Brazil? Those areas are a lot closer, are less competitive, and a lot of companies also go there to outsource as well.

Art Marks of Valhalla Partners:



You know India has been a great outsourcing location, but wage inflation has been 15% to 25%. Turnover has been 25% to 30% per year; the rupee inflated 15% in 2006. Infrastructure cost—or should I say costs to offset the lack of infrastructure—are probably 30% of the operating budget and the outsourcers in India are starting to outsource to Vietnam, Sri Lanka, even China. I am saying that I can use those tools I developed to get cheaper labor and our companies are using Eastern Europe; they are using Argentina. They are not limited to one place. They are finding certain sources of talent through personal relationships, through industry relationships, and they are leveraging them all over the globe.

Jim Breyer of Accel Partners:

We have six general partners in Palo Alto; we have five in London; we have seven in Beijing and Shanghai. Our feeling is that we can do one strategic initiative every two or three years, whether it is a new geography or a new sector. No doubt, Argentina represents a phenomenal opportunity. A number of our companies find that Brazil, over the last 12 months, has represented a lion's share of their growth. Of course, that means that we are way under plan in the US. But the fact is that these are attractive markets from which highly attractive entrepreneurial leaders and venture capitalists will emerge. I am not sure if we, as US venture capitalists, bring all that much, unless someone has a deep passion for a certain geography and wants to spend four to five weeks a year in one of these geographies to help make things happen. Whether it's Eastern Europe, whether it's Russia, there are certain geographies where small, focused venture capitalists are likely to do very well over a long period of time.

Peter Wendell of Sierra Ventures:

The focus of your question was South America and with regard to the Princeton endowment, in the last 18 months, at least two or three venture firms Princeton has funded are South American-based. They are all local natives. I think there is little evidence of US venture firms having effectively penetrated down there. But there is good promise of local firms, some of whom have had knowledge because they worked in the Valley for a while, or they came here to Stanford or Harvard or somewhere. I think they will be a growing market there. Obviously, the risks are different; the political climate and the political stability are different. Certain norms of doing business are different, but it is a very promising place.

Q2: Just as a small number of firms among the funds that perform generate a huge amount of returns, a few deals also generate a lot of the returns. Has anyone thought about changing the model to figure out on the front end which deals may be those great deals? How do you view the question of whether to be less diversified, to be more concentrated?

Peter Lawrence of FLAG Capital Management:

We have been trying to work around that "more concentrated, less diversified fund" issue. It has been a little hard to tell because the last several years have not shown a lot of distinguishing deals. I just do not trust the data. Intuitively, we think that the 25 and fewer companies are going to outperform. It looks that way in our early modeling but frankly, I just do not trust the data. Josh may have a little better sense for it. But it goes to the question of, "Can you just fund your winners from day one?" There is that issue of attention to deals. If you're in your first fund, do you really do a lot better than your later funds because you've got all this free manpower to devote? We have done a little tracking in that area, first through fifth fund, trying to



see which funds do better by vintage year comparisons. The third is a definite no-no. But certainly one looks good; two looks okay. Four looks just great. If you get to four here, you are going to have a great fund.

Moderator:

Of course if you turn down the third fund, you will not be allowed to invest in the fourth fund.

Peter Lawrence of FLAG Capital Management:

That's for sure. So you are going to live through that third one. But it is a little too early for us to tell about concentration.

Jim Breyer of Accel Partners:

I think if a firm had a clean sheet of paper that is exactly the right way to build the business. Within Accel, we never get partner consensus on whether you can identify, early on, which the good deals are. I think there are a number of us, myself included, who do believe in a smaller number of deals, higher ownership, taking a little bit more risk and building a model around that. I think we have some very experienced, brilliant investors who believe you can never tell which ones are going to work, and so go for a diversified investment strategy. Don't try to predict what will work. Try to be smart and 5 to 10 years later some of them will have worked out great.

I believe that the classic model of raising 500 million dollars, which is at least the model we've been operating under for the last couple of years, and investing in 40 companies, is not way off. I personally think we would be better off investing in 30 or so companies than 40, but not 20 and not 50. There is just some basic math and a lot of it relates of course to the capital intensity of the businesses. But it comes down to personalities and whether it is among generations; everybody comes at it in very different ways.

Art Marks of Valhalla Partners:

If I may, it is an ideal model, but it is not the only model. I think Tim Drapers has done one of the most innovative models, and done the opposite. He spent a little bit of money on a lot of companies and those that survive will fund the second time or the third time. It is more of a Darwinian model.

Q3: From a macro perspective, as we look over the next 5 or 10 years, what two or three things do you foresee that may create less headwind in the venture capital business, so the trend can be our friend again?

Jim Breyer of Accel Partners:

Well, I think the point Bill raised is that we have absolutely abysmal public policy when it comes to what we're doing with foreign students, what we're doing in terms of how we are thinking about long-term capital gains versus short-term; I could go on and on. I am an unabashed free market person, as probably several people in the room might be. But I would also say that for our economy, I don't have any particular insight except that we have really struggled at Walmart and we believe that we will continue to struggle.

I think that we are going to see retailing comps that are just dreadful over the next couple of days. We are starting to see Target and others. Anybody in the venture business who is investing in consumer Internet or enterprise software networking



who believes that we will be immune is smoking something. I think that is going to be a real challenge for all of us who are building models where we try to be capital-efficient relative to these companies. We may very well go back into a mode where we have to really temper the growth and the head counts and, in many cases, start to cut back just to get through what might be a very difficult 18 or 24 months.

Art Marks of Valhalla Partners:

My understanding is that this year, the venture industry is going to invest about \$30 billion. Almost a third of it is in two sectors—biotech and cleantech, fairly capital intensive, depending on many people's money and both of them targets of government intervention. That was being spoken of broadly in the political elections, so those two sectors will be disrupted. I do not know which way the winds will blow. You know, a good north wind will take us up the river and a good south wind will wash us out to sea.

Peter Wendell of Sierra Ventures:

I expressed optimism before about the quality of people coming into the industry and the quality of new firms that have managed to get funded. But as to some of the factors that will drive near-term returns in our business, I would be less optimistic. The first of them is the amount of capital flowing into our industry, particularly from outside the United States. There are still many, many asset allocators outside the United States who want to allocate assets to US venture capital. Obviously, if we had half the capital available to the industry than was available now, you would think the returns might go higher if it acted like most rational financial markets. But I do not think that there will be a sudden drying up of the capital coming into our industry. That is one thing that could change the headwind.

Another is economic conditions in the US, and that does not look like it will be our friend for the next year or two. Public policy aside, there is just the overall performance of the domestic economy; most of us have our portfolios quite heavily tied to the US economy and that is not going to help the headwind issue either. So on some of the near-term factors, I cannot be as enthusiastic as I am about some of the longer-term factors I referenced earlier.

Q4: What are the trends in asset allocation across the alternative investment?

Peter Wendell of Sierra Ventures:

A lot of people from outside United States do not have a deep knowl—edge of the venture capital industry but are very anxious to get capital in. They just have a certain asset allocation that they really want to get in US venture capital, not realizing that merely throwing up an asset allocation will not get them what they want. It is just my personal experience in the markets, and then seeing when Princ—eton deals with some of these first-time funds. It is a marker to people outside the US; an imprimatur. It does not warm my heart that the amount of capital versus the number of deals equation is about to change for the good.

The asset allocators like buyouts because they can get more money to work more quickly. With venture capital we tend to be smaller, bite-size, and we tend to take longer to get taken down. With the private equity firm, you can get a big bite size, and they will take all your money real quick and check off the asset allocation. Oh,



jeez! Great! I just got another \$300 million in the US. Well, putting it out is easy, but the problem of getting back more than you put out would be somebody else's problem; you will see, they will not have to worry about that.

Prof. Bill Sahlman (Moderator) of Harvard Business School:

People forget how bad the buyout business was for an extended period of time. All of a sudden the buy-out business got great, as price-earnings ratios went up and access to capital became essentially free. Interest rates went down; covenants went away. We are now reversing the entire thing, throwing a recession on top of it. The reality of our asset allocation market is that it is easy to put large amounts of money to work in that sector, but it is going to be a total disaster.

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