



VENTURE CAPITAL: IT'S A
PRICING, NOT A VALUE, GAME!

The Core VC Competitive Advantage?

The WSJ headline..

Returns Are In

Andreessen Horowitz's first three venture-capital funds, in millions

	Amount raised	Distributions	Unrealized gains	ROI*	IRR**
Andreessen Fund I	\$297	472	301	2.6	42%
Top 5%				2.6	40%
Top quartile				2.1	24%
Andreessen Fund II	611	439	965	2.3	25%
Top 5%				5.8	74%
Top quartile				2.4	33%
Andreessen Fund III†	1,441	329	2,184	1.7	27%
Top 5%				2.3	51%
Top quartile				1.6	30%

*Return on investment **Internal rate of return †Combines main vehicle and parallel fund

Note: All figures after fees and as of Dec. 31

Sources: Cambridge Associates,
Wall Street Journal reporting

THE WALL STREET JOURNAL.

And the Scott Kapor response..

□ Realized versus Unrealized Returns

Unlike investments in public equities, where the unrealized returns are based upon observed market prices for traded stocks and can be converted to realized returns relatively painlessly, Unrealized returns at venture capital funds are based upon estimates and that these estimates are themselves based upon opaque VC investments in other companies in the space and not easily monetized.

□ Potential noise and bias

Implicitly, he seemed to be saying that not only are unrealized returns at VC funds subject to estimation error, but also to bias, and should thus be viewed as softer than realized returns.

Price versus Value

The Investing Game: Estimate what a business is worth based on its capacity to generate earnings & cash flows

The Pricing Game: Estimate what other people are willing to pay for similar businesses

INTRINSIC
VALUE

Value

THE GAP

1. Is there one?
2. If yes to (1), does it have to close?
3. If yes to (2), when?

Price

PRICE

Drivers of intrinsic value

- Cashflows from existing assets
- Growth in cash flows
- Quality of Growth

Tools for estimating intrinsic value

- Discounted Cashflow value
- Accounting value

Drivers of price

- Market mood & momentum
- Incremental information
- Liquidity

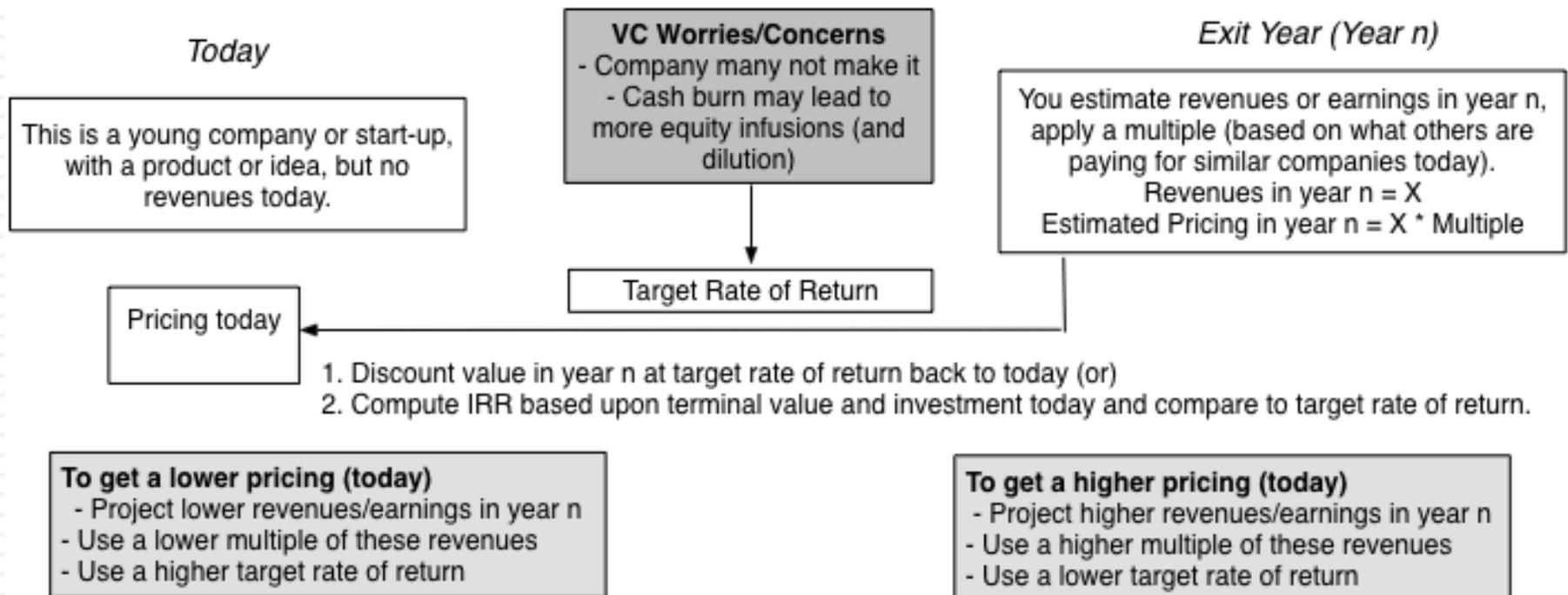
Tools for pricing

- Multiples & Comparables
- Charts & Technical Indicators

VC Pricing Approaches

- Recent pricing of the same company: Pricing is based on what VCs paid for the company (and priced it at) in the most recent venture capital round
- Pricing of similar private companies: Look at what investors are paying for similar companies in the “same space” (with all of the subjective judgments of what comprises “similar” and “same space”), scale this price to revenues, or lacking that, a common metric for that space, and price your company.
- Pricing of public companies: In the rare cases where a private business has enough operating substance today, in the form of revenues or even earnings, in a space where there are public companies, you could use the pricing of public companies as your basis for pricing private businesses.

And a forward variant



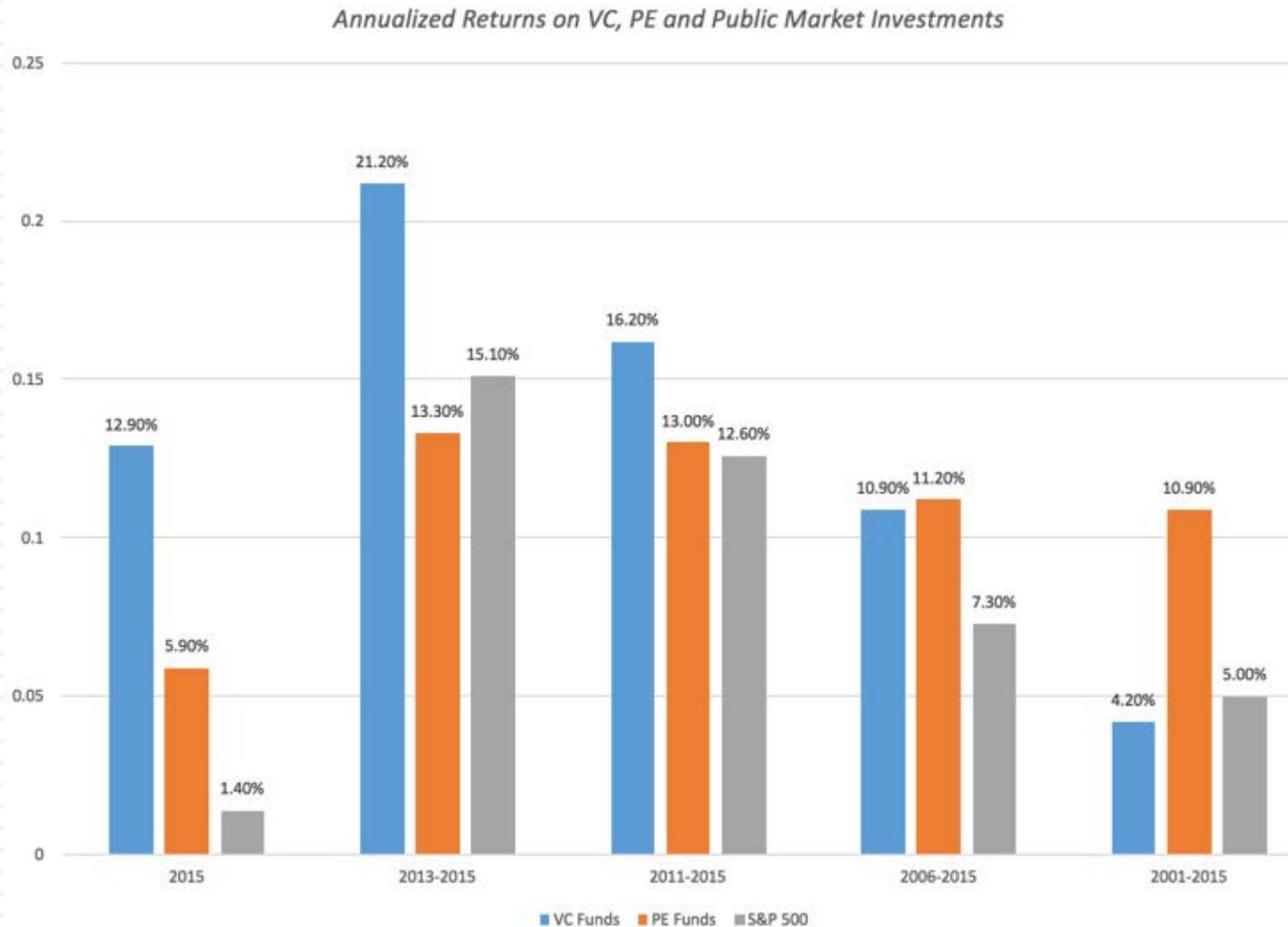
The VC Pricing Problem is statistical..

- Small Samples: If your pricing is based upon other private company investments, your sample sizes will tend to be much smaller, if you are a VC than if you a public company investor.
- With Infrequent Updating: Private company transactions are few and far between. In many ways, the VC pricing problem is closer to the real estate pricing than conventional stock pricing.
- And Opaque transactions: Unlike public equities, where a share of stock is (for the most part) like any other share of stock and the total market value is the share price times number of shares outstanding, extrapolating from a VC investment for a share in a company to the overall value of equity can be and often is complicated.

With predictable consequences

- More error: The pricing that I obtain will have a larger band around the estimate and there is a greater chance that I will be wrong.
- More bias: The pricing will be more subjective, since you have the freedom to choose your comparable firms and often can use discretion to adjust for the infrequent data updating and the complexity of equity investments.
- The pricing will lag the market: When transactions slow down, and VCs hold off on full repricing until transactions pick up again, there can be a significant lag between when prices drop at young companies and those price drops getting reflected in returns at VC firms.
- There is a price feedback loop: One badly priced transaction (in either direction) can trigger many more badly priced transactions.
- And a time horizon issue: Winning at the VC pricing game may require that you take a position in a young start up and bide your time until you build it up and find someone who will find it attractive enough to offer you a much higher price for it.

In spite (or because) of the pricing problems, VCs seem to outperform..



And elite VCs stay elite...

- The most successful VCs not only earn higher returns than the top public market investors but that there seems to be more consistency in the VC business, insofar as the best of the VCs are able to generate higher returns across longer time periods.
- That would suggest that venture capitalists bring more durable competitive advantages to the investing game than public market investors.

Perhaps using these competitive advantages..

- They are better pricers (relatively): While all of VC prices are undoubtedly wrong (because they are estimates), some of them are less wrong than others. You just have to be less wrong than everyone else and the chances of you doing that are greater in the VC pricing game.
- They can influence the pricing game: VCs can take a more active role in the companies that they invest in, from informally advising managers to more formal roles as board members, helping these companies decide what metrics to focus on, how to improve these metrics and how (and when) to cash in on them (from an IPO or a sale).
- They have better timing: To be successful, you not only have to time your entry into a business right but even more critically, time your exit from it.