The Venture Capital Deformation

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Value Destruction throughout the Investment Process

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Thanks be to God

Preface

In spite of the robust development of venture capital that has occurred over the last three decades (as measured by the amounts of fundraising and investing), returns from venture capital have been declining. This book focuses on a simple question: why? The answer lies in the context of multiple deformations that have occurred throughout the venture capital process. This process, comprised of six specific phases (fund formation, deal generation, screening and evaluation, and deal completion, monitoring, and exiting), serves as a canvas for our analysis. In short, value destruction in venture capital occurs throughout these phases. This unique perspective permits us to delineate in which phase of the process financial returns are compromised.

Deformations in venture capital occur at two broad levels. Firstly, venture capital deformations and value destruction occur as a result of the interactions between venture capital firms (commonly known as general partners, or GPs) and their investee firms (i.e., entrepreneurial firms). GPs struggle to provide the most optimal combination of capital and know-how assistance to entrepreneurial firms. As a result, venture capital may have sub-optimal or even negative effects on entrepreneurial development, value creation, and innovation. Moreover, venture capital financing makes a relatively small contribution to entrepreneurial development. Deformations and value destruction also occur between GPs and their capital providers (namely, limited partners or LPs). There has been growing dissatisfaction among LPs with respect to GPs' performance and conduct on multiple fronts; areas of issue include declining financial returns, compensation structures, misalignment of incentives, information disclosure, contractual arrangements, and so on. Consequently, LPs are either increasingly questioning the validity of the venture capital model or entirely avoiding the venture capital asset class.

The Structure of the Book

This book has a simple, transparent, and easy-to-follow structure (see figure below) consisting of three sections: two chapters (i.e., a introduction to venture capital), six chapters (i.e., a description of each phase of the investment process), and two concluding chapters.

The venture capital investment process and the venture capital value chain

The introductory section of the book includes two chapters. Chapter 1 focuses on the definition of venture capital, its characteristics, and the advantages and disadvantages of venture capital from the perspectives of LPs and entrepreneurs. The introductory chapter also differentiates between the "j-curve" and "n-arch" in venture capital investing. It is important to note that to simplify matters, this book uses the term venture capital as the primary description of investing into private firms. This means that we also include private equity in our considerations. Chapter 2 discusses the maturation of the venture capital industry and distinguishes the two major market sub-segments in which venture capital firms compete; this information is presented on the basis of Michael Porter's six forces model.

The second section is dedicated to describing the six phases of the venture capital investment process. Chapter 3 focuses on key issues related to venture capital fund formation. Here, we specifically focus on constitutional, structural, operational, and compensation deformations and discuss how these areas contribute to value destruction in venture capital. Chapter 4 focuses on deal generation or "deal flow" in the context of two models of value generation: the "natural" and "accelerated" modes of entrepreneurial value creation. Chapter 5 focuses on venture capital screening and due diligence. In this chapter, we highlight some of the key problem areas in venture capital due diligence and decision making. Chapter 6 focuses on deal completion and some of the inequities in financial contracting that occur between venture capitalists and entrepreneurs. Chapter 7 discusses the actual hands-on assistance provided to entrepreneurial firms by venture capitalists. Chapter 8 focuses on venture capital exits, namely, the “financial monetization” of venture capital’s illiquid investments.

The third section of the book offers concluding remarks. Chapter 9 focuses on the financial returns generated by venture capital in the context of the venture capital process. This chapter presents a “value chain” analysis of the venture capital investment process and discusses in which phase of the process financial returns are likely to be “compromised.” The last chapter of the book focuses on the future of venture capital in the context of potentially improving the substandard business model.

The Book’s Unique Perspectives and Features

Venture capital is a popular subject for books; in the last five years alone, there have been more than 40 books written on the subject. The proposed book is distinguished from other books focusing on venture capital in a number of ways. Firstly, our book aims to understand the key reasons behind declining venture capital returns—this is the primary focus of our analysis. Secondly, the book assesses the long-term impact of venture capital on entrepreneurial development. Thirdly, we provide a comprehensive view of venture capital through the eyes of the various stakeholders in the venture capital ecosystem, including advisors, consultants, LPs, and entrepreneurs. Lastly, the book focuses on some of the most controversial topics in venture capital today, such as venture capital compensation and lawsuits against venture capital firms, and so on. This critical assessment of venture capital is presented in a uniform and comprehensive manner.

The book aims to provide readers with a comprehensive examination of venture capital and its impacts. We believe that academics, students, practitioners, and especially entrepreneurs need to be more cognizant of venture capital’s many underlying weaknesses; these drawbacks are especially pronounced in relation to entrepreneurs. Secondly, the book aims to counterbalance other books that are predominantly “affirmative” on the subject of venture capital. Thirdly, the book offers a balanced combination of theory and practice—it provides sound theoretical foundations, yet has many useful, practical recommendations and observations for both entrepreneurs and LPs. This practical orientation is a strong feature of the project. Fourthly, the book offers “in-chapter inserts”—special supplements that provide real-life examples of specific issues covered in specific chapters.

This supplementary material was developed on the basis of actual case studies and illuminates some of the key points of our discussion. In many cases, these inserts highlight points that are either entirely omitted or poorly discussed in most academic studies.

We have followed a hybrid approach to generating information for this project; this was necessary because many of the book's key areas of focus have not been exhaustively covered by specific streams of writing and there is no complete research on certain topics. We first conducted a thorough review of academic literature and aimed to reconcile some divergent views. Secondly, we relied on industry reports and studies, which allowed us to note that mainstream academic literature has some "knowledge gaps" in research with respect to venture capital. This review was also important because it allowed us to make some of the most practical and experiential observations found in the book. Thirdly, we completed a thorough search of newspaper articles and online material. This material seemingly appears to offer singular reflections or cases, but if reviewed jointly, it allows one to discern key themes and questions previously unexplored by academics. Fourthly, we have conducted interviews with industry players to test our initial hypotheses and conjectures. Lastly, where necessary, we supported available secondary research with proprietary data.

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In order to complete this book project, I have relied on a number of formal and informal consultations including discussions with academics, venture capital practitioners, and various consultants and advisors operating in the venture capital system. I have also benefited from comments from anonymous referees, who encouraged me to rethink certain aspects of this book. I would also like to thank Kyle Lougheed, who has provided invaluable editorial assistance on all of my publications since 2003. Many thanks to David Taylor and Heather Gillander from Brandon University for their interest, encouragement, and support. I would also express gratitude to Jerzy Strzelecki for many inspirational discussions. Lastly, I would like to express gratitude to deans Bruce Strang and Demetres Tryphonopoulos from Brandon University, who have granted numerous course reliefs for me to work on this project. Of course, any omissions and shortcomings in this book are solely my own.

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