

Peeling Back the Onion: LPs Get Tougher on Due Diligence

Venture Capital Update

May 2009

Written by:

Katie Knepley
Principal
650.855.3025
kknepley@svbcapital.com

Bronwyn Dylla Bailey
Research Director
650.855.3021
bbailey@svbcapital.com

With the news of fraud perpetrated by a few notable individuals, many financial observers have wondered how these scandals could occur in today's Information Age. Some in the media have singled out incomplete or faulty due diligence by the victims of fraud.¹ Given the widespread impact of some alleged Ponzi schemes, such as Bernard Madoff's fund, even investors in credible, ethical funds are taking extra precautions to assess their existing investments and potential new investments. Limited partner investors (LPs) in private equity, who have a fiduciary duty to their organizations, are taking even more care in their investment decisions due to today's economic and financial climate.

In this *Venture Capital Update*, we examine areas in which LPs are focusing more due diligence and monitoring. While SVB Capital's investments are

concentrated in venture and growth capital, these best practices can be applied to most private equity due diligence.

As a manager of funds of funds, SVB Capital is an LP in the underlying venture capital funds in our portfolio. We conduct due diligence and monitor these funds on a continuous basis. We also meet with our own limited partners when they are conducting their due diligence to invest with us and to help them monitor their investments after they have committed to our funds. With our dual role, we are well-positioned to discuss these recent trends in due diligence and monitoring. This article provides a summary of the areas of due diligence that have become more important to LPs and where they are spending more time gathering additional information.

View the [Fourth Quarter 2008 U.S. Private Equity Snapshot](#) >>

FIVE AREAS FOR INCREASED DUE DILIGENCE

LPs have typically spent significant time digging through information about venture capital General Partners' (GPs) portfolios and strategy. Now LPs are feeling the weight of their fiduciary responsibility and are taking even more time to review the finer details of an investment. Increased LP scrutiny is paired with greater willingness by GPs to share more information and spend more time to help LPs become comfortable with the asset class, return expectations and future strategy. In our recent experience, LPs have been focusing their due diligence on the following areas: 1) team dynamics, 2) investment strategy, 3) cash flow management, 4) performance attribution, and 5) alignment of interests.

1. LPs Look for Cohesive, Enduring Teams

A cohesive team is one main ingredient for developing a portfolio of profitable companies and, ultimately, a successful fund. Some of the best firms, such as New Enterprise Associates or Battery Ventures, are managed by teams of managers who have been together for decades or more. However, economic difficulties, such as a recession, can put stress on even the best of teams and LPs are paying closer attention to changes in team dynamics.

Given today's environment, LPs expect some management teams to become more aggressive in removing members who have not been performing. In addition, it is expected that only venture capitalists with patience and discipline as well as a real passion for working with young companies will be successful in developing winning companies through these difficult times. Nonetheless, GPs should be prepared to address turnover in the senior and mid-level investment levels, since LPs could view these changes as a signal of stress.

LPs look for firms with team policies that incorporate plans for succession and ways to filter out non-performers. Moreover, a team with healthy dynamics establishes policies to effectively compensate investment professionals who have talent, sector expertise, and proven track records. To assess team dynamics, LPs will often interview team members, together and separately, to determine their level of satisfaction with team dynamics and compensation. LPs with more extensive networks will address this question with co-investment partners or other LPs of the firm.

2. LPs Eschew Strategy Drift

In a rapidly changing market, it is tempting for a team to drift from their historical strategy towards an area

that appears to provide quick and easy returns, or to go where the money is—i.e., strategies where LPs seem to be investing more capital. Some LPs state an aversion to strategy drift but at the same time want fund managers to take advantage of unique investing opportunities. Dow Jones reports that LPs today are demanding a “back-to-basics” approach, which includes smaller funds and investment strategies with a tighter focus.²

GPs can provide LPs comfort around changes in strategy by providing more transparency and focusing on the sustainability of future returns. Strategies can change, but an LP should have enough information to ensure that the firm continues to match the LP's original risk-reward expectations. A firm should clearly articulate its strategy and show that it has dedicated sufficient and appropriate resources to it. For instance, if a firm has moved its focus away from balanced stage strategy and towards more late-stage investing, an LP will look for information that verifies the market opportunity for this type of investment strategy. LPs will also seek evidence that the firm has managers with extensive experience in helping companies become market leaders and that their network and skill set is appropriately oriented to generate successful exits.

3. LPs Expect VCs to Manage Cash Flow and Reserve Management Proactively

One area where SVB Capital sees LPs expanding their inquiry is around cash management and reserve policies. We believe that this area will separate successful managers from their less successful counterparts during this period of illiquidity, which we expect to last at least through 2010.³

SVB Capital has noticed GPs are taking extra precautions to ensure that their funds remain capital efficient and available capital is channeled to the best companies. Some GPs are regularly updating models of each portfolio company's capital needs and exit expectations to ensure that the GPs understand how the current pace of progress by portfolio companies and market conditions will affect companies' need for capital. The models are used to balance recycling and adjust reserves to work toward the best return outcomes, while also managing capital draws and distributions to the LPs. The end result is a proactive scenario model, which is used to plan capital calls and keep the funds' LPs well-informed.

SVB Capital has heard that LPs are asking fund managers to delay capital calls because of tight liquidity, making it more difficult to manage investments and reserves prudently. GPs may be forced to examine second-best options for some of their portfolio companies in

order to provide liquidity to the fund. For instance, a GP may be willing to sell a company sooner for a potentially lower multiple in order to provide cash to the fund. This cash would then be available to distribute to LPs or recycled back into the fund to support their highest potential companies. Both options benefit LPs by providing distributions, delaying additional capital calls or funneling investment dollars towards the best companies. Given the liquidity crunch that many LPs currently face, it may be in the interest of both GPs and LPs to find creative ways to provide liquidity for the fund.

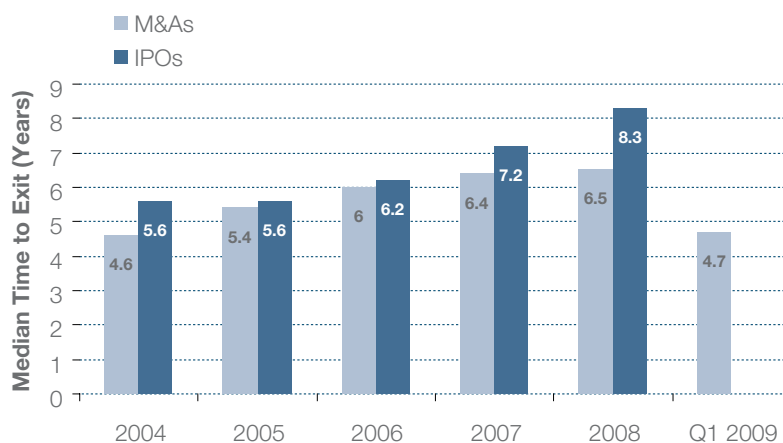
Metrics for mergers and acquisitions (M&As) during the first quarter of 2009 provide some evidence that GPs are beginning to focus on early liquidity and

may sacrifice a shot at a homerun for a certain base hit. The chart below shows that in Q1 2009, the market saw fewer venture-backed exits through M&As (68 compared to 104 in Q1 2008)—and at much lower valuations (\$22 million compared to \$60 million in Q1 2008). Surprisingly, the median time to exit has declined dramatically as well, from 6.8 years in Q1 2008 to 4.7 years in Q1 2009. While one quarter does not necessarily indicate a trend, it does provide evidence that GPs were willing to exit selected portfolio companies more quickly than in any year since 2004, albeit at lower valuations.⁴

4. LPs Dig Deep to Determine Performance Attribution

Under current economic conditions, it

Time to Exit Falls in the First Quarter 2009



Sources: Dow Jones VentureSource. Time to exit is measured as the period between first financing and IPO or M&A exit. Yearly data are annual medians. There were no venture-backed IPOs in Q1 2009.

is expected that performance of venture capital and other private equity funds will decline in the short-term. It is at this time that LPs are taking a closer look at their investments to understand their performance to date and expectations for future returns.

The best due diligence provides an investment thesis about where a fund's returns will come from. To build this thesis, LPs investigate the factors that generated performance in the past. For instance, LPs are now seeking—and receiving—more detailed information from fund managers on underlying companies and performing a bottom-up analysis of performance. With this additional information and time spent on analysis, LPs are able to tie attribution to specific individuals more consistently. LPs can then determine which team member sourced the deal and which member sat on the company's board and worked with the company through its sale or public offering.

After understanding which specific attributes—whether it is the GP, the market, or one special company—is providing value to the fund, LPs will assess whether these factors or people are present in the current fund. Analyses at this granular level provide clear insight into current and projected performance of a firm, but also increase the time it takes to conduct due diligence and may delay investment decisions.

5. LPs Expect Agreement Terms to Align Interests

In the last few years, LPs were eager to invest in venture capital and private equity funds, but access to the top tier funds was extremely limited and over-subscribed funds were common. As a result, LPs typically viewed the negotiation process with GPs as one in which the GPs held the upper hand. Today, many LPs believe that the tables have turned. LPs have limited amounts of capital to invest, and they have become more careful about where they invest and with whom they form a trusted partnership.

The main goal in assessing the terms of LP Agreements is to confirm that LP and GP interests are aligned. At the same time that LPs are eschewing funds in which profits seem mainly tied to management fees rather than carry, many LPs are seeking out funds that return to the “old venture model.” In this model, GPs invest more of their own capital in the fund, team salaries are reduced and the rewards from carry are greater. GPs are highly incented to develop winning companies that produce big exits. This model also serves the interests of both GPs and LPs—strong returns for GPs provide large gains for LPs.

When negotiating LP Agreements, LPs should be mindful about the factors motivating GPs to invest in good

companies. These terms include GP contributions, carry, GP clawbacks, and handling of director stock options and other fees generated by the fund. While the lack of liquidity may have created a power shift between GPs and LPs, the main goal is to create an agreement that keeps all partners' interests aligned.

ASSESSING RISK IN RISK-AVERSE TIMES

In private equity, there are as many ways to assess risk as there are potential perils. In this article, SVB Capital discusses areas where LPs are taking more care to fulfill their fiduciary responsibility by assessing the risks that could lead to poor returns. LPs are asking venture capitalists to provide more information and spend more time with them before LPs become comfortable with investing in their funds. Consequently, LPs are taking longer to conduct due diligence in certain areas before committing to new investments.

The best due diligence ultimately takes time and effort to understand more clearly the people and strategy in which you are investing and to verify your findings with the venture and private equity community. Thorough due diligence utilizes an extensive network for references (outside of the GP's reference sheet), a bottom-up analysis at the portfolio company level, and the development of a thesis around

the source of returns. In conducting such methodical due diligence, LPs must also balance the reduction of investment risk with the chance of tainting the relationship with a GP. This level of analysis is often best conducted by trained professionals with experience identifying acceptable risks and the ability to find ways to create value for the GP. SVB Capital believes the added investment of time and resources on the front end will pay off in the long run.

TELL US WHAT YOU THINK

Send your comments and suggestions for topics to Bronwyn Bailey at bbailey@svb.com.

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¹ The Securities and Exchange Commission has also been blamed for the lack of oversight of Bernard Madoff's hedge fund operations. Source: Binyamin Appelbaum and David S. Hilzenrath, "SEC Didn't Act on Madoff Tips," The Washington Post, December 16, 2008.

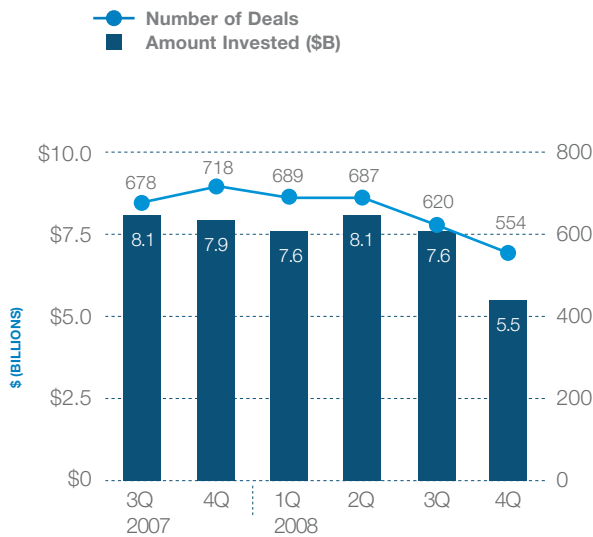
² Russell Garland. "Venture Investing Hits 11-Year Low in First Quarter," Dow Jones VentureWire, April 20, 2009.

³ Our expectations agree with the predictions of many VCs. In the NVCA's predictions survey for 2009, 72% of more than 400 VCs respondents did not expect the IPO market to re-open until 2010 or later. Source: National Venture Capital Association 2009 Venture Capital Predictions Survey Results, December 17, 2008.

⁴ Data from Dow Jones VentureSource.

Fourth Quarter 2008 U.S. Private Equity Snapshot

U.S. Venture Investing Activity



Source: Dow Jones VentureSource

Most Active Venture Investors

Firm Name	Assets Under Mgmt \$(MILLIONS)	Number of Deals*
North Bridge Venture Partners	2,647	17
Draper Fisher Jurvetson	4,214	15
U.S. Venture Partners	3,825	13
Accel Partners	6,000	11
Edison Venture Fund	650	10
New Enterprise Associates	9,743	11
Venrock	2,200	11
Polaris Venture Partners	3,049	10
SV Life Sciences	1,537	10
Advantage Capital Partners	700	9
GMEA Capital	1,171	9
First Round Capital	172	9
Mayfield	3,206	9
Menlo Ventures	4,000	9

Source: Dow Jones VentureSource

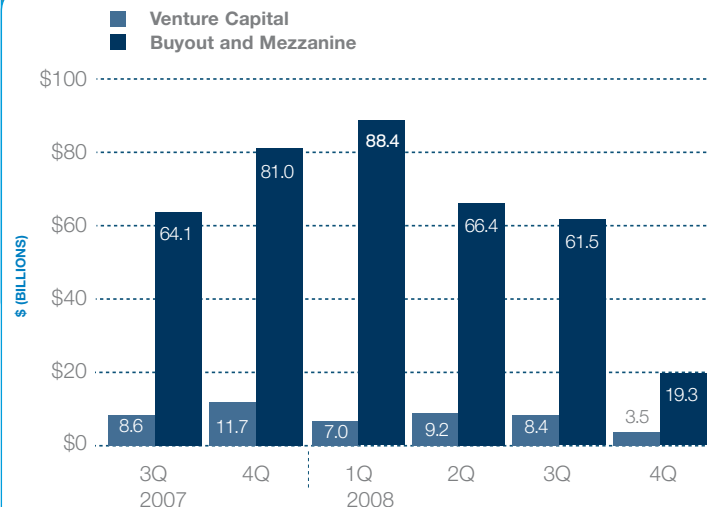
* U.S.-based portfolio companies only

Venture Investment by Region, All Industries

U.S. Region	Num of Deals	Num of Investing Firms	Average Per Deal \$ (M)	Sum Inv. \$ (M)
Bay Area	159	212	\$12.9	\$1,931.8
New England	77	108	9.4	727.9
Texas	20	40	24.8	496.1
New York City Metro	55	85	7.1	380.2
Colorado	15	32	22.9	343.7
Midwest	35	51	6.5	230.3
Potomac	23	45	8.6	193.6
San Diego Metro	14	41	13.1	182.5
South	27	58	6.0	157.1
Washington State	18	28	5.6	113.8
Los Angeles Metro	22	47	5.1	105.8
Research Triangle	5	18	29.0	102.6
Philadelphia Metro	17	23	3.7	70.5
Oregon	6	10	4.7	28.5

Source: Dow Jones VentureOne

Fundraising by U.S.-Based Venture and LBO/Mezzanine Firms



Source: Thomson Reuters VentureExpert

IRR Performance (%) by Vintage Year (U.S.)

Vintage Year	Num of Funds	Cap Wtd Avg	Pooled Avg	Upper Quartile	Median	Lower Quartile
1996	36	59.2	83.0	113.9	33.8	1.4
1997	62	46.1	49.5	59.7	20.1	(0.8)
1998	77	23.9	18.4	10.8	1.8	(3.8)
1999	110	(6.8)	(5.5)	0.8	(6.6)	(14.6)
2000	125	0.4	1.4	2.6	(2.4)	(7.1)
2001	57	3.1	4.3	9.6	1.5	(3.9)
2002	20	1.9	3.9	3.8	0.3	(2.3)
2003	17	7.0	7.0	7.3	4.8	2.1
2004	23	3.7	3.9	10.5	(0.7)	(6.3)
2005	17	4.3	8.0	12.0	5.5	(1.7)
2006	29	(3.4)	(1.7)	7.0	(6.3)	(12.7)
2007	18	(17.8)	(10.0)	(6.2)	(15.1)	(24.3)
2008	4	(60.9)	(70.9)	(28.4)	(57.0)	(73.4)

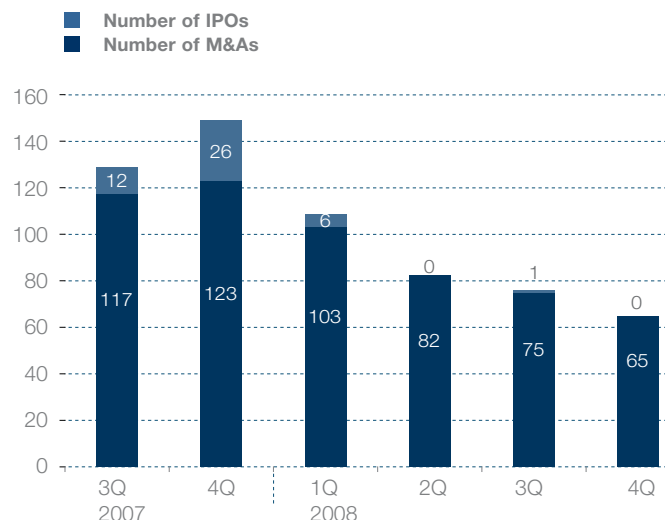
Source: Thomson Reuters VentureXpert. Data as of September 30, 2008.

Cumulative IRR Performance (%) by Stage (U.S.)

Fund Type	Num of Funds	Cap Wtd Avg	Pooled Avg	Upper Quartile	Median	Lower Quartile
Early/Seed VC	602	9.2	19.0	15.6	3.4	(4.6)
Seed Stage VC	68	1.1	9.3	13.7	4.4	(1.0)
Early Stage VC	534	9.6	19.9	15.9	3.3	(4.9)
Balanced VC	456	8.2	13.8	14.8	5.5	(0.7)
Later Stage VC	205	6.6	13.5	14.8	5.5	(0.8)
All Venture	1,263	8.3	15.5	14.9	4.8	(2.2)
Small Buyouts	181	8.7	15.5	17.4	7.6	-
Med Buyouts	115	11.9	17.2	21.9	8.8	(0.9)
Large Buyouts	98	10.6	12.0	18.0	7.3	-
Mega Buyouts	134	(5.0)	10.7	15.2	6.0	(0.6)
All Buyouts	528	(1.2)	12.1	18.0	7.5	(0.3)
Mezzanine	72	6.3	8.2	12.8	7.3	1.3
Buyouts and Other PE	696	(0.3)	11.5	16.5	7.3	(0.1)
All Private Equity	1,964	1.9	13.2	15.4	5.8	(1.6)

Source: Thomson Reuters VentureXpert. Data as of September 30, 2008. Figures for all funds in database, vintage years 1969-2008.

U.S. Ipo Vs M&A Transactions For Venture-Backed Companies



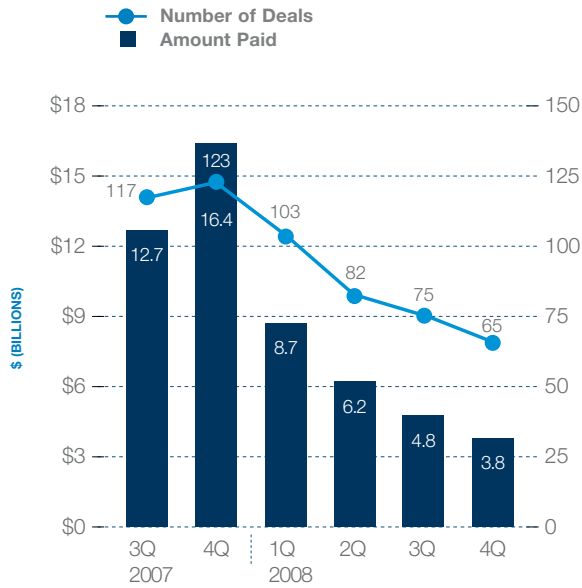
Source: Dow Jones VentureSource

US. Venture Liquidity Events by Industry

Industry	2006		2007		2008	
	IPO	M&A	IPO	M&A	IPO	M&A
Business and Fin. Services	7	63	5	77	0	37
Cons. Goods and Services	2	25	5	27	0	13
Energy and Utilities	1	4	1	6	0	0
Biopharmaceuticals	20	38	18	28	1	24
Healthcare Services	0	9	2	8	1	7
Medical Devices	6	32	10	20	2	13
Medical Software and IT	2	18	3	11	0	9
Ind. Goods and Materials	2	2	1	5	0	3
Comm. and Networking	5	52	10	41	0	29
Elect. & Computer Hardware	1	18	3	13	0	16
Information Services	1	20	4	31	1	26
Semiconductors	2	21	6	21	0	24
Software	7	171	8	169	2	124
Other	0	0	0	0	0	0
TOTAL	56	473	76	457	7	325

Source: Dow Jones VentureOne

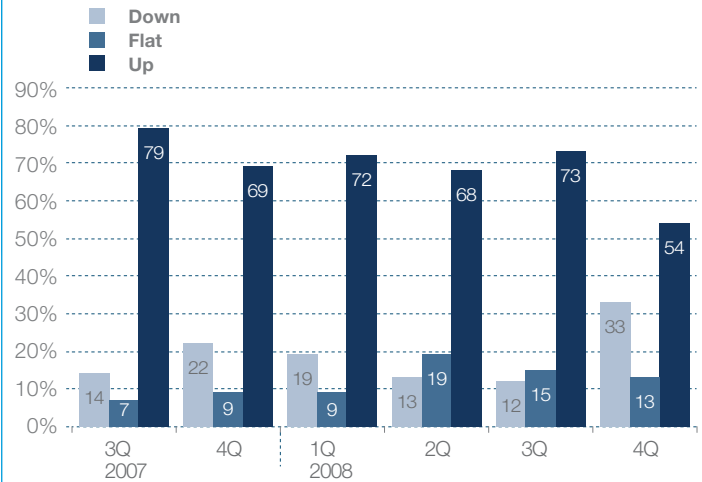
U.S. Venture-Backed M&A Activity



Source: Dow Jones VentureSource

Price Change

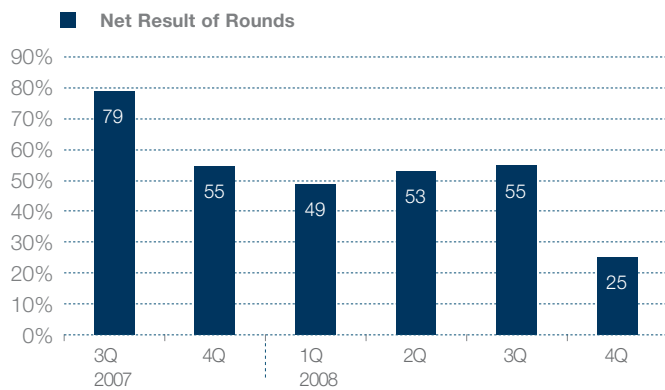
The direction of price changes for 128 San Francisco Bay Area companies receiving financing, as compared to their previous rounds.



Source: Fenwick & West L.L.P.

Venture Capital Barometer™

Average per share % price change from previous round of Silicon Valley companies receiving VC investment in the applicable quarter. Complete report available at <http://www.fenwick.com/vctrends.htm>



Source: Fenwick & West L.L.P.

SVB> *Find a way*

SVB Financial Group

SVB Capital Headquarters

2400 Hanover Street Palo Alto, California 94304

Phone 650.855.3000

3000 Sand Hill Road, Building 3, Suite 150 Menlo Park, California 94025

Phone 650.233.7420

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