COMMENTARY

A Report of TIFF EDUCATION FOUNDATION

2010 Edition 1

Highlights

On October 1, 2009, the TIFF Education Foundation (TEF) hosted in Cambridge, Massachusetts, the most recent edition of its highly idiosyncratic Endowment Management Seminar series. Modeled loosely after the broadcast series *Inside the Actors Studio*, the October event mimicked its predecessors in that it presented interviews with five highly respected institutional investors. The 2009 Edition 4 *Commentary* covered three interviews conducted by TEF President David Salem, and this *Commentary* comprises excerpted transcripts of the two remaining interviews, conducted by TIFF staffers Stephen Vicinelli and Chris Douvos:

Michael Eisenson, managing director of Boston-based Charlesbank Capital Partners, reflects on his extensive experience on both sides of the proverbial private equity table – GP and LP – and on philanthropy circa 2009; and

Josh Kopelman, managing partner of VC firm First Round Capital, discusses the climate for innovation and entrepreneurship while exploring the changing landscape of venture capital investing.

About TIFF

Mission. In 1991, a network of foundations founded a cooperative-style investment organization whose structure and eligibility criteria have evolved over time but whose core mission has not. Known colloquially as TIFF, this organization seeks to improve the investment returns of endowed charities by making available to them a series of multi-manager investment vehicles plus resources aimed at enhancing fiduciaries' knowledge of investing.

Means. The organization comprises three regulated entities at present: a tax-exempt private operating foundation whose d/b/a (TIFF Education Foundation) is more descriptive of its focus on education than its formal legal name (The Investment Fund for Foundations); TIFF Investment Program (TIP), a regulated mutual fund family; and TIFF Advisory Services (TAS), a taxable non-stock corporation and regulated investment advisor to TIP that administers as well many other investment vehicles bearing the TIFF name.

Inquiries. For more information, please call TIFF at 610-684-8000 or visit www.tiff.org/TEF.

Michael Eisenson

Stephen. Our next speaker hails from the exciting world of private equity, although for anyone who has read a paper in the last six months, "exciting" no longer conjures images of *Masters of the Universe* but rather Senate hearings exploring the wanton use of leverage, general partners acknowledging they raised too much money, and admissions by many that deal pricing was too high to generate positive returns.

Michael Eisenson, the CEO and co-founder of Charlesbank Capital Partners, is a different type of private equity pro. His approach is what I'd call "old school" — an approach to investing that many of us now long for as we reflect on a period during which some fear the industry has lost its way. In 2007, a different time for private equity, I congratulated Michael at his firm's annual meeting on its excellent performance. Rather than bask in the compliment, Michael leaned forward with a serious face and said, "Don't expect this to last. It doesn't feel quite right and it will correct." All I could think was, "Wow, what a buzz-kill." I'd just been brought down to earth by Doctor Doom.

Alas, he was right. Today, we've asked Michael to help us think about the serious issues the industry is facing. Michael, investors in your new fund clearly see a bright future for private equity investing. But I've heard many others say that the LBO is dead, venture capital is broken beyond repair, and the liquidity offered by public equities will always trump the incremental alpha private equity firms claim they can generate. Does the private equity industry need to change, and do you believe it will?

Michael. There's no question that the industry, broadly defined, got off track. People were seduced by the abundance of credit, and frankly, the abundance of equity capital. This will lead to a recalibration, probably some winnowing of firms. It's distracting to think of private equity as a single activity. What we do and have done for 20 years is very different from the LBOs you read about on the front page, and it's very different from the venture capital business. It's easy to over-anticipate the death of private equity. You just have to look back to the venture capital world in 2000 and 2001, when results were very bad and there were pretty much uniform predictions that venture was over. But by 2004 and 2005, record amounts of money were flowing back into venture capital, and it was as if the bad results had never happened. Part of that arises from short memories, and part of it is hope springing eternal. But part of it is also that the private investment business is a fundamental part of the economy. It has been since the 1950s and will continue to be. Some lessons we just keep learning over and over. One is that the business doesn't scale. We seem to need to prove that to ourselves regularly. The business of sifting through hundreds of possible opportunities to find three or four interesting places where assets have been mispriced, or finding opportunities to grow cash flow that somebody else missed, hasn't disappeared. This type of business has always been good to our investors and us. A lot of what private equity morphed into didn't embody this type of business over the last few years. Another lesson we re-learn periodically is that it's not as easy as it looks to do the business well, and it takes more than just hard work. It requires discipline. We went through a period of 12 months where we were not able to make a single investment because of pricing. That's really hard to do in an investment organization. But as I say, I think it's a fundamental business where there's a fundamental opportunity to find mispriced assets and companies that we can work with and improve.

Stephen. I'd like to ask about the public face of private equity. In the early days of the recent LBO boom, when private equity was front-page news every day, a German politician famously referred to private equity practitioners as locusts. Beyond grabbing a few headlines in an election year, did this man have a point? Does the private equity industry need to do a better job projecting its image?

Michael. I didn't feel like a locust! There probably is a public relations challenge, but it's not the kind of thing I'd be inclined to get involved with. Fundamentally, the industry has done a terrible job for its investors. If it had produced attractive and durable returns, the public relations issue would be much more easily addressed. Although there were probably some abuses, I don't think private equity was a material contributor to the global economic downturn. The one place where public relations could be helpful is when private equity firms become public firms. I can't imagine that the world understands the good of a PE firm becoming public. What the industry needs to do is just produce good returns and it will come back into respect.

Stephen. I'd like to ask about how private equity firms organize themselves. Many in the audience will know that certain private equity firms effectively have become supermarkets, expanding their teams to offer investors a fund for nearly every possible strategy or geography under the sun. Yet other firms have stuck to their knitting, offering a single strategy, typically in a single geography. The supermarket can offer significant convenience. But the à la carte approach of best-in-class private equity managers has produced excellent results. Can you go both ways? Is one way better than the other?

Michael. We think being focused is best. We've thought a lot about it. It's hard not to be a little bit cynical in responding, and I apologize, but I think the most obvious drivers of the supermarket model are not of any use to limited partners. The most obvious drivers are to get big fast. That was a compelling proposition to some people when the IPO ring was out there to be grabbed. A second obvious driver is to grow management fees rapidly; you don't need to be a supermarket to do that, but a supermarket can do that in a less obvious way. I remember having my limited partner hat on at the college I'm involved with, and we were looking at a venture fund in 2007. They were raising $400 million, which was very consistent with their past practice. When we looked a little bit more closely, however, their fundraising calendar involved raising eight funds in four geographies totaling over $3 billion. So the supermarket strategy, if you were cynical, might be a way to seek $3 billion in $400 million increments and somehow make people feel better about it. A third driver that's really not very useful to the limited partners is that the supermarkets allow the general partner to diversify its carry risk. If you have four different products working at any one time, one of them is bound to succeed, and they're disaggregated. There may be some "one-stop-shopping" benefits to limited partners in the supermarket model, although convenience isn't a big enough benefit to justify making investments of tens of millions of dollars in one place. The one driver that I could imagine being of use is that some firms have diversified to create opportunities for their younger partners without diluting the more senior partners. However, my view is that more senior partners at some point should make their contribution elsewhere, including me. This is a business that you mature out of, and you can control that problem by controlling growth rather than by creating products. So generally speaking, I don't think the supermarket model is a great evolution.

Stephen. Some of these firms appear to be comfortable banking themselves as well, a situation that seems rife with potential issues. Is this a one-off, pre-credit-crunch phenomenon? Or should we expect to see more of these supermarkets starting as private equity firms and developing into broad financial institutions?

Michael. In a way, it's a natural evolution, because the investment banking firms moved into principal investing. For the principal investing firms to move into investment banking, since they were competing on their private investing side, seems like an almost natural evolution. For us, it would be unnatural. We're taking a company to market now, and there are eight investment banking firms competing for the business. It's impossible for me to imagine that we would have a captive unit that would be better than all eight of them. From the point of view of our investors, we'll get better execution by taking that business outside. The same is true on the debt side.

Stephen. Let's turn to what you do. How is it possible that some firms are able to invest and add value to companies as diverse as insurers, retailers, restaurants, and oil-field equipment manufacturers? Tell us what it is that a good private equity firm brings to the table. Is it industry knowledge, or something else?

Michael. You randomly selected industries that are all in our portfolio! I'll tell you what we don't do. We don't pretend to either be competent operators or experts in all those sectors. We think of ourselves as reasonably good at bringing to bear the right resources, ultimately determining whether an investable hypothesis has emerged, and, if so, how to structure the investment. There are very different schools of thought. There are firms focused by industry – energy services, media, insurance, and telecommunications are great examples. There are firms that are generalists but have experts on staff, in the form of operating partners or people who invest just in one sector. And then there are firms like ours that are simply generalists. I'm sure all three models make sense for certain groups – we are contrarian investors, so the generalist model just works better. It's the least intuitive, but it's something we've thought a great deal about. We don't focus in a given area, because as contrarians, our experience has been that there are cycles when assets are priced more attractively and less attractively. For example, we've just made an investment in an energy services firm. Today's investment is driven in part by the fact that credit has disappeared from the Master Limited Partnership (MLP) universe. The MLPs owned all the assets and now they have to divest. So there's an excess of supply of assets over demand. We last made an investment in the energy services sector in 2002 following Enron's bankruptcy, because there were five or six companies in the country that owned all of the mid-stream assets, and they all were facing bankruptcy. We don't have an energy specialist on our staff, but we have a network of people we can turn to. We have 30 CEOs invested in our fund. We've been at this a long time and we know a lot of folks who are experts. Our view has been that we can bring the right expertise to bear at the right moment, but we don't have that expertise on staff when perhaps it's the wrong moment. We're not attempting to add sector expertise. We're really attempting to add investment judgment and investment structuring expertise.

Stephen. Let me ask you the same question in a slightly different way. Following a successful or unsuccessful outcome – and we have all had some investments that don't end up working – if any of us were to speak to the CEO of that business, and they were to point out where you were able to add value or not, what do you think they'd say?

Michael. I'll draw a distinction between adding value to the companies versus adding value to our investors, because those are two different things. They're complementary but different. We add value to our investors in part by buying low. That doesn't help the company, but it actually helps our returns. We add value to our investors by trying to avoid mistakes. That doesn't help the companies either, but it's good for our investors. The places that we try to add value inside the companies are as follows: First, we help CEOs think about corporate strategy. Of our 20 investment people, 17 have spent time in corporate strategy firms. Our approach is really fundamental strategic analysis and then strategic development. The average enterprise value of a portfolio company of ours is $250 million. Most of the CEOs of companies of that size have not spent a great deal of time thinking about strategy development. So we focus there. We help with identifying places where the management team is not deep enough and finding people to fill those roles. We'll occasionally make changes at the senior-most levels of management, but that's not our preferred course. We help with capital markets issues, because we're in the capital markets every day and our CEOs aren't. We help with merger and acquisition activity. We're really the investment arm of our companies. Many grow in part by buying smaller companies in their industry, and that's a place where we spend a lot of time. We also help in exit planning and execution. For investments that fail, folks wouldn't point to that as a particular value-add, but that's a place where we gear up. We don't try to be operating people. When I talk to our new people, I often say, we're not trying to be amateur operators, we're trying to be professional investors. So we don't substitute ourselves for the operating people; we try to make our contributions running alongside them.

Stephen. I'd like to ask you about partnership agreements. Despite being referred to as "limited partnership agreements," many investors view the typical private equity term sheet as outmoded and highly favorable to the general partner. It appears that the current market has given investors far more leverage than they have had in recent years to introduce new ideas, most of which, not surprisingly, would be beneficial to limited partners. As a GP, you recently completed a fundraising. Did you face pressures that you had not seen before on term sheet issues? And with your LP hat on, is this the time to fix agreements that need fixing?

Michael. There's no question that some agreements needed fixing. The issues were not subtle or technical. They were glaring. There's a need for investors to limit the assets deployed by any given firm at any given time. There's a need to make a conscious decision about what fees can be charged by whom and for what. There's a need to limit the distractions that some general partners seem to be inexorably pulled by. There are many funds that still have no preferred returns, which is especially true in venture capital, but it's even true in the buyout business. There are agreements that are really bad and they need fixing. But it's not subtle and it's not a 72-item list. Our agreements, in my view, have always been middle-of-the-road. That's always been our instruction to our lawyers — to produce a middle-of-the-road, balanced document. We've never pushed the carried interest. We've traditionally split every source of income or profit 80-20 with our limited partners, which I'll get back to in a minute. We've always had a preferred return. We've always had a one-product focus. That being said, we did get lots of questions and comments on our term sheet this time, which was very interesting because we received lots of comments on terms that were essentially unchanged from our last fund when we received no comments. So it really wasn't our document. It was more about what was going on in the world. People were responding to bad things that had happened to them, which is not surprising. There were three areas that have some visibility today where we did make changes in our document, and they were all areas that were much more significant to the limited partners than to the general partner. One was the issue of ancillary fees, which were a source of substantial abuse in the LBO business. They'd never been a significant part of our business; we have averaged $400,000 a year in ancillary fees over the last decade. That's quite different from the $40 million per transaction that people have been reading about. But nonetheless, that was an important issue for LPs. It wasn't important for us, so we now attribute all ancillary fee income to our limited partners. We've always had a provision that enabled us to waive management fees as part of our investment in the general partner, but we never actually used it. That was an issue that had tremendous visibility in the limited partner community. People were very exercised about that, but since we never used it and never planned to, we took that provision out. The other term that was significant to limited partners was the no-fault divorce clause. We never had one, and my feeling was always that if 75% or 80% of our limited partners showed up at our office and told us they didn't like us anymore, we wouldn't keep investing. But maybe people had that type of experience elsewhere, so we now have a no-fault divorce clause. For the most part, our investors, and I myself as a limited partner, are more inclined to look at a pattern of practice over time. People who didn't abuse the leverage when it ran in the general partners' favor are unlikely to be abusive when the leverage is running the other way. In my own experience, where I saw abuses, the abuses weren't subtle. They weren't minor technicalities.

Stephen. The secondary market has become a more vibrant one for limited partners who would like to get liquidity from illiquid investments, which is a relatively novel concept. I'd love to hear your thoughts on whether increased selling of partnership interests on the secondary market has had an impact on the industry, and if so, whether it's a good thing or if it introduces new problems for GPs or LPs.

Michael. This is an area I'm speaking about without a great deal of personal experience, because only one small secondary interest has traded in any of our funds to people we know well. But I think as a general matter, it can be good for the industry. It's a good thing when commitments to funds end up in the hands of people who want them and leave the hands of people who don't want them, and end up with people who have the capital and inclination to continue. It's good for the limited partner universe, but I think it's also healthy for the general partner universe, with one important caveat. We spend a lot of energy trying to be thoughtful about who our investors are. So we have a unilateral approval right over transfers. The reason is not to exercise pricing power but rather to make sure our other investors end up with a partner who'll be complementary. We avoid some investors who are disruptive when we're raising a fund, and we really don't want to end up with them through a secondary trade. So with that caveat, my view is it's generally healthy for the industry.

Stephen. Shifting gears, I have a few questions about co-investments. It strikes me that co-investing cycles in and out of favor depending on availability of capital and market sentiment. Ironically, some of the best private equity returns have been generated during periods of significant market dislocation and scarce capital availability. This suggests that most co-investments happen at precisely the wrong time. Who benefits most from co-investments, and are you seeing co-investment interest on the part of limited partners today?

Michael. Co-investment is generally a poor idea and is not in the best interest of LPs. It can occasionally be helpful to general partners. Co-investing is a different business than selecting partnerships and selecting managers. It requires a different staff and a real commitment to the time, energy, resources, and structure to do direct investing. Co-investing requires a commitment to hiring people who are experienced at direct investing. But there's a more subtle problem: it makes good economic sense if a limited partner were to co-invest in every transaction with a general partner, but where that doesn't happen — and it never does — there's an almost insurmountable adverse selection problem. If a general partner finds an investment that's really attractive, they'll figure out how to stretch every possible resource to take as much of it as they can. If, on the other hand, they find an investment that they're sort of ambivalent about but it just makes the hurdle, they'd probably like to do a little less of that and share it with their friends. Even the best-intentioned general partners are going to fall prey to that. When I first got to Harvard [Management Co.] in the late 1980s, co-investing in the venture capital business had been Harvard's strategy for private equity. I took a look at a firm – one of the preeminent firms in the country – where Harvard had had a history of making more than 20 co-investments over a period during which the general partner had reported 30%-plus returns. However, Harvard's return on that portfolio of more than 20 co-investments was zero. I know the general partner was not targeting Harvard for bad deals, because we were their most important limited partner. But the adverse selection problem that results is unavoidable. So I'd be really careful about it. We've generally sized our funds to be able to make smaller investments, but we occasionally find a much larger investment. If we had limited partners who had the resources, as we do today, and the inclination to co-invest, we'd certainly bring those investments to them. And I would certainly hope that we weren't adversely selecting. For example, when we had a $300 million fund 12 years ago, we came across an investment that required $500 million of equity. So it was pretty clear we weren't going to do that whole investment. But that's the kind of circumstance where it's clear that there was no adverse selection at work. Co-investing can be a real minefield.

Stephen. Good segue to my next question. You've run both a captive private equity group within a large institution and an independent firm. Are big institutions better off hiring external managers or doing direct investing, as opposed to co-investing, themselves?

Michael. It really depends on whether the institution is willing to take the time, energy, and resources to build an experienced investment team. Having a team of multi-purposed people whose principal business is manager selection is not going to be a successful approach to direct investing. We found at Harvard years ago that we had to develop two entirely different teams with different compensation and support structures. We physically separated private investing from public investing, because the pace of each business is completely different, and the way you measure success is completely different. I think it's possible, but it's difficult. Many institutions I've observed try and then lose heart. Sometimes they lose heart over compensation issues. In the private investing business, the better practitioners are willing to be paid just for performance, but they actually do expect to be paid for performance. Many times, people get right up to the line and then falter. It's a commitment you have to make, and it takes a long time to master. Our office is very active for ten or 15 hours a day, and it's always active on the weekends – it's very different than public market investment activity, which is probably a lot more intense in the hours that it's active, but it's just got a different pacing and a different culture. It requires a real investment. It requires a lot of time. That said, today is probably the best time if you were going to try hiring some direct investment people, as there are more available in the market than ever before.

Stephen. What advice would you offer to someone embarking on a career in private equity today?

Michael. They had better be patient. Opportunities are serendipitous; there isn't an obvious career path; and most firms hire opportunistically. Today probably isn't a great time to actually get a position. But if somebody were truly interested in private equity as opposed to venture capital, a good way to go is to get experience in a firm that provides an essential service to private equity. Most private equity firms I know hire primarily from investment banks, where people are closely involved with companies, or from consulting firms, which is our case. I would tell people not to be overly discouraged. I got out of school in 1981. I was keenly interested in private equity. I got one interview at what was then the largest firm in the industry that had fewer than 10 people in it. I wasn't able to get a position, so I spent five years at Boston Consulting Group and then actually took a very non-traditional route into the industry through Harvard. Being patient and being willing to have private equity as a long-term objective as opposed to a short-term one is important. It's also very important not to take just any job. This is an apprenticeship business where judgment is critical. I would say to a young person that it's really important to find a place where you have a mentor or a number of mentors, because that's going to be critical. I've had the opportunity to have this conversation a lot with younger people, and I always tell them to have a backup plan, because Plan A could take a while.

Stephen. You don't find any older people asking you the same questions?

Michael. I do, but I discourage them!

Stephen. If you could do anything other than manage money for a living — and make twice as much doing it as you make now — what would you do?

Michael. Two things come to mind. First, I'd be a jazz pianist. I've always had that ambition. I come to the Regattabar at this hotel [The Charles Hotel] regularly to listen to jazz, and it's fantastic. That's really improbable in my case! My other ambition might be to run a foundation that was well-funded and had a broad mandate, because I think there are a lot of interesting things you could do today in the world with directing capital to problems. I'd work for a foundation where my job wasn't to go out and raise money but rather to think about how to invest the money, which would be an interesting complement to what I've done and would be really exciting for me. If you have any of those opportunities that pay twice what I'm currently being paid, let me know!

Stephen. Hold that thought, because I want to come back to it. But first, another question: which person, dead or alive, has served as the most inspirational role model for you personally, and why?

Michael. I'm going to cheat and mention two people, because they represent different sides of my life. On the personal side, my parents really dedicated their entire lives to raising four children. I have four children. I think a lot about the time and energy and commitment that they made and the absence of hobbies during that period of time. I probably think about that every day. On the professional side, I've had the opportunity to work with some really terrific people. I'd say that the eight years I spent working directly with Jack Meyer [at Harvard Management Co.] were really formative. I don't think there's a more levelheaded or clear thinker about the investment business than Jack. His approach to decision-making has been really fundamental and formative for me.

Stephen. You're very involved in many philanthropic activities, and, in particular, with Horizons for Homeless Children. Could you tell us how you got involved and what the organization means to you?

Michael. I have a fair number of non-profit involvements, and they've been really important to me since I began my career. Horizons is my longest-standing and deepest involvement. It focuses on providing pre-school and other services to homeless children and their families in Massachusetts. We started it 20 years ago. I got involved with three friends. We were all in our mid-30s and interested in doing something other than just donating money to organizations. We had just started writing our United Way checks, because we had a little bit of discretionary income, but we were interested in doing something a little bit more hands-on. We decided we wanted to find a problem that was real, that was addressable, and that nobody else was working on. At that time, the question of homeless children was really off the radar screen. We thought what we could do for those kids was actually provide high-quality pre-school so they could get to school without being way behind their peers. We started in 1989. Our first year budget was $3,500. The four of us funded that with checks that were material to us. We've all stayed with it. Today, we have three full-time pre-schools in Boston and 175 kids in those schools from 8:00 a.m. to 6:00 p.m., 52 weeks a year, and we provide services to their parents that help them get out of the homeless situation, through job training, placement services, or housing services. We have more than 1,000 volunteers working every week in every homeless family shelter in Massachusetts, of which there are 150, providing part-time child-care in all those locations. We have a full-time staff of 100 people. It's the largest organization of its kind. It's Massachusetts-focused, because we were really interested in doing something in our community. It's been enormously time-consuming and enormously rewarding. All four of my children have worked there, which was part of my thinking in getting involved in the first place. I, like many people in the room, grew up in very basic circumstances. My family was a construction family, and as a first-generation college person, I had this fear as I began to have children that they would be chronically over-privileged. I was keenly interested in finding some way to introduce them directly to a part of the world that they weren't going to see in their daily lives. That actually has been a nice side-benefit for me. Most important, though, is the fact that we've had well over 1,000 families who've been through our program who were homeless but are now housed and employed and functioning in society.

Stephen. A wonderful note to end on. Thank you very much.

Michael. My pleasure.

JOSH KOPELMAN

Chris. The very notion of venture capital conjures up mythical archetypes: cocktail napkin business plans, late-night garage tinkering, world-changing technologies, frenetic IPOs. But the lofty aspirations of yesterday have evolved into what some today see as comfort-seeking. Josh, however, has been forging ahead making investments while others are pulling back. A recent article in *BusinessWeek* stated, "Even faced with a financial world aflame, Kopelman is running straight for the fire. It may be bravery or foolishness." We'll let you be the judge. Josh, you enjoyed great success as an entrepreneur before crossing over to venture capital and really studied the VC industry when doing so. Talk about some of the dynamics and trends that were underway when you decided that VC might be a good vector for your talents and time.

Josh. I had a smooth transition from running a startup to being a VC. I'd actually argue that I'm doing my fourth startup right now. It's just that my fourth startup is a venture firm. Most successful entrepreneurs find unmet market needs that translate to opportunities, and then move to address them. That's what we've tried to do with First Round.

I've started three companies. My first was Infonautics. It took us $5 million to get to first product shipment back in 1993. The second company, in 1998, was Half.com, which took $2.5 million to get to market. The third was TurnTide, an antispam router company that took $750,000 to get to market. Today, we're routinely seeing software-based companies that get to market on a couple hundred thousand dollars. I'm not talking about life sciences or hardware, but rather software-based companies.

There was a dramatic shift from 1993 to 2003, when we started First Round Capital. During that time, venture firms got much larger. In fact, the average venture firm tripled in size during that period, and the average initial investment tripled. We saw entrepreneurs needing less capital, being more capital efficient, and venture firms seeking less and less inefficient companies in which to deploy capital. I started off as an angel investor; I did 40 angel investments and set up a small seed fund, of which I was the primary LP. I moved to a more institutional fund but did so as I validated a thesis of underlying changes in venture investing based on declining costs to get to market but also changes in exit opportunities.

Chris. What is it about the entrepreneurial DNA that's different?

Josh. I'm not sure if it's the DNA that's different. Barriers to entry have been transformed. For my first company, we spent $200,000 doing market research before we came to market, because we knew we'd need $5 million behind it. Today, you're getting to market for $200,000. As recently as 2002, I was a seed investor in a company called Feedster — a bad investment. Our first purchase was an EMC network-based storage unit. We had to spend $800,000 to get into business. Today, the CEO of that company can take out a credit card, go to Amazon web services, where they have storage in the cloud, and pay 25 cents per gigabyte. An $800,000 check isn't needed anymore.

Entry costs have been lowered so much that now people who previously didn't have the capability, the network, or the experience to spend 18 months fundraising, are able to start a business using networks of friends, family, or co-workers. These networks allow them to scrape together the couple hundred thousand dollars they need to get into business. It's changed the time to market, but it's also changed the time and cost to failure. It used to be that when you started a company it took so long and you had to raise so much money and there was so much inertia that it took longer to get to market. By the time you failed, you had three to six years in it. Now, companies are able to validate or disprove a hypothesis quickly, so you have real efficiency in terms of entrepreneur turnover — entrepreneurs executing against ideas with real opportunity rather than playing out ideas that will ultimately fail.

Chris. You've often said that as a seed investor it's your role to validate, disprove, or de-risk the entrepreneur's hypothesis. Thinking of yourself as an entrepreneurial venture capitalist, and of the hypotheses you've formed, which have been disproved and which have been validated?

Josh. We're still a work in progress. We don't know until the end. What I would say, though, is that the concept of micro-cap venture, seed stage venture, super angel, VC 2.0 — whatever name you use — venture capital entails finding capital-efficient companies, enabling them to validate or de-risk, and in some cases to gain traction. We've found that for every $1 million we've deployed, it's been followed by over $30 million of follow-on capital. So that part of the model is working.

We initially thought that a large part of the value we'd add to our ventures would be in recruiting. We were wrong. It turns out that when a company has $400,000 in the bank, their ability to attract top-level talent is pretty low. We also thought this would be difficult for later-stage venture firms to truly do. It's hard when you have so much money under management. The challenge is not writing the $250,000 or $500,000 check, the challenge is spending time. You're not dollar-constrained, you're time-constrained. You're seeing later-stage venture firms – the bulge bracket venture firms – write some seed-stage checks. But we're seeing a real diversification and separation of the micro-cap ventures and the bulge cap venture funds.

Chris. Some of the bulge bracket venture firms are great sources of capital for your growing companies as well as great sources of referrals of companies to you. Bulge bracket venture firms fill very different roles in the ecosystem. Let's talk about some challenges these bigger VC funds face.

Josh. When we were deciding what size fund to raise, we did some math. Let me walk you through it. Take a typical $400 million fund today. To get a 20% return over six years, you have to triple your capital, turning $400 million into $1.2 billion. Now, it's going to take longer than six years, and you have to add fees and carry, so that $400 million fund roughly has to return $1.5 billion to the investors to get a 20% return.

On exit, that fund will own at most 20% of a company — the founder owns some, and there are multiple VCs, but on average it's about 20%. That means that a $400 million VC fund has to create $7.5 billion of market value to return $1.5 billion to its LPs in order to deliver a 20% return. When you look at some of the exits in the Internet and software arenas, if one fund had funded Skype, which had an exit of over $2 billion, and that same fund funded YouTube, which had a $1 billion exit, and the same fund funded MySpace, the good news is they'd be halfway toward achieving their objective. This is a shift I refer to as "the great experiment."

We're now seeing the results of a ten-year experiment in venture capital. Twelve years ago, venture firms were smaller. In general, when you look at the amount of money that's going into venture and the amount of returns they need to have, I'm much happier with a smaller fund.

Chris. As are your investors! Let's talk about entrepreneurs. What advice would you give to an entrepreneur starting out today?

Josh. The biggest mistake I made in all my startups was not understanding the importance of flexibility in the pivot. You spend a lot of time putting together your model and your business plan, and you've been very rigorous. What I've come to learn about business plans — and I see 2,000 a year — is that the only thing they have in common is that they're all wrong. The minute you hit save, print, or send, a business plan is out of date. Competition changes, regulations change, pricing pressure comes into play, technology shifts. Most entrepreneurs think that when they accept a term sheet, they have this covenant with their investors to go off and execute their business plan – wrong! You don't want an entrepreneur who has the idea du jour; what you'd rather have is the entrepreneur open to pivot. YouTube started off as a dating site, PayPal started off as a technology to beam money from Palm Pilots to each other. What these companies' founders did was listen to the market, listen to feedback, and understand when and how to pivot. Pivoting is two things: having the mindset and antennae up to gather information from customers, competitors, advisors, and investors. Collecting that feedback is important, but it's also important to build a culture and business relationships that are flexible enough to pivot if needed.

My first company, Infonautics, built a product called Homework Helper back in 1993. It was LexisNexis for junior and senior high school kids back when they were dialing up on 300- and 900-baud modems. We said we were going to offer unlimited access to 2,000 magazines and newspapers for $9.95 a month. We signed over 2,000 contracts. It was only after we were in the market for six months that we realized we had the pricing wrong. We spent the next six months renegotiating all of those contracts because we didn't have the foresight to structure the contracts to allow ourselves to pivot. When I meet entrepreneurs today, I work hard to truly understand them. My biggest challenge is that I don't think I'm really good at assessing any particular entrepreneur's ability to predict the future, which is what a business plan is. What I try to assess is their ability to adapt and change. I think that's a big skill that is underrated.

Chris. There was a great article in *Wired* magazine about Netflix. What struck me about it was their willingness to walk away from some very large sunk costs. Netflix was literally three days away from market with a set-top box.

Josh. They spun it off and gave it away to another company.

Chris. That was an epic decision. Talk about courage among venture capitalists and what you see in boardrooms.

Josh. When it comes to startups, courage is basically about risk and how entrepreneurs and VCs manage it. Most good entrepreneurs don't like risk. Most good entrepreneurs are in the risk mitigation or risk elimination business. When they start off, they're willing to embrace risk, but their plan of execution is to say, "What are the biggest risks facing this business and how can I validate, de-risk or disprove those risks?" Most good entrepreneurs are able to identify which ones are the most important and nail them. So when you meet with an entrepreneur with a model of maybe 30 unknown variables — they don't know their cost of customer acquisition, they don't know the commission rate — there are so many unknowns. Entrepreneurs have to be able to accept this and realize that all 30 risks aren't equal. There might be five or six that create a disproportionate amount of enterprise value, and if you could get answers, or even just move the guardrails on those risks, you're creating major value by reducing them. In boardrooms, the challenge is when entrepreneurs and VCs disagree over which five are important.

Chris. For those of you who don't know, Josh is an acclaimed blogger, and I and others have learned so much from reading Josh's thoughts and ideas. Talk about Domino Rally and how it relates to venture capital.

Josh. When I was a kid there was this game, Domino Rally, where you'd get dominoes and spend hours and hours setting them up. After four hours of mind numbingly putting the dominoes on the course, you'd push the first domino down and have 30 seconds of pleasure watching all of the dominoes fall. There's a certain class of businesses we see now that we call Domino Rally businesses, because they have to deal with risks embedded within each other. Assume first that we could convince a major cell phone carrier to install an app and then convince people to download it. Very quickly, you begin to see the dominoes. How many things need to fall in order to have success? The point of Domino Rally was that if any one of those dominoes was misplaced, you wasted all of your time.

When we look at businesses, we're looking at how many dominoes need to fall for a business to get traction and be successful. We also look at how many of these dominoes are in a company's control versus a third party's. One of the underappreciated beautiful things about the Internet is that any company can reach any consumer without going through a gateway. That's revolutionary, at least in the technology space, because historically if you wanted to reach consumers you had to box your software product and sell it to retail. That was a domino. That was someone in your way. If you couldn't convince CompUSA to carry your product, you couldn't get it out there. That's why some of the Internet businesses have gotten such traction; there are fewer dominoes in the way helping them to get big really quickly.

Chris. You describe yourself as a coastally challenged VC. That's because you live in Philadelphia for personal reasons but spend a lot of time in the Bay Area. In fact, First Round has been described by some people as a national seed-stage firm, a term that simultaneously thrills and terrifies me. What is it about the Bay Area that makes investing there so compelling, more so than, say, Boston or New York?

Josh. I'm from Philadelphia, and Philadelphia has some wonderful theaters. There's the Kimmel Center, the Arden Theater, the Forest Theater, the Prince Theater, the Merriam Theater, the Walnut Street Theater. But there's not one college kid who comes to Penn and says, "I want to be the king of the Walnut Street Theater." They're going to Hollywood or to Broadway. That's where the ecosystem is for acting. That's where raw material — talent — can get the most velocity.

At First Round, we believe there are great entrepreneurs everywhere. We also believe there are certain ecosystems that can profoundly shape and scale their growth. A disproportionate number of our investments are in San Francisco and New York, where we have offices. From a venture perspective, there's a really interesting geography arbitrage available, because a lot of VCs who are in San Fran or New York don't look outside these areas. We saw a company called StumbleUpon in Calgary, Canada, and we were the only VC firm that funded them. They moved to San Francisco, and a year later eBay acquired them for a very good return. We came across a company made up of three guys in New Haven called VideoEgg and encouraged them to move to California. They had their first $1 million revenue day last week.

We recognize the importance of ecosystems but also recognize the geography arbitrage available by funding great raw material and talent in unconventional places and then connecting it with robust ecosystems. I'd also say, though, that the ability to add value to distributed companies has changed tremendously in the last decade. I don't know if the world is flat, but I know the country is. I have all of the CEOs on my instant messenger list, I'm tracking some of their locations on Google Latitude. The ability to have Skype conversations and see what they're doing through Twitter or Facebook makes me so connected to them individually. These tools also give me the ability to stay connected to the business. Everyone is using SaaS-based tools [Software as a Service]. I logged on from my hotel room this morning and went to Google Analytics. I could see 12 of my portfolio companies and how they did yesterday. I log on to Salesforce and can see my enterprise sales companies' pipelines. If I want to know their financials, I log onto Quickbooks online and the data is right there.

By using these software-based tools, your ability to stay connected to companies and understand what's going on allows you to operate far more effectively than you ever could have previously. You can be quietly intrusive rather than directly intrusive!

Chris. Let's fast forward 10 or 15 years. Are the nation's innovation hubs still the Bay Area, Boston, New York, Austin, and other interesting little clusters like Minneapolis? Or is innovation much more broadly distributed?

Josh. The concept of network effects makes sense. As more people move to LA, and more talent agents base themselves in LA, and more film production companies crop up in LA, it becomes very hard to dislodge LA as the entertainment capital of America. The same thing applies to Silicon Valley and other hubs. You have these network effects, and I wouldn't underestimate the traction and the force of companies based in VC hubs. I have a company in Pittsburgh and a company in San Francisco, and seeing the challenges the company in Pittsburgh faces that the company in San Francisco doesn't, I find it hard to imagine that areas like Pittsburgh will overcome the network effect in terms of company formation and talent pool. In fact, we're seeing that the entrepreneurs we're backing are coming from all over the world to Silicon Valley.

Chris. Some non-US entrepreneurs trying to come to the United States bemoan the challenges they face getting visas. Yet many people are looking to entrepreneurship to help lift the US economy. In other words, there's a lot to be dismayed about and a lot to be optimistic about.

Josh. As a VC, I have to be an optimist. The barriers to getting into business have come down tremendously. For a small local business, its ability to reach customers now is different from ten years ago. Today, you can whip out your credit card and buy Google AdWords, you can set up a Twitter account, as realtors do, and have hundreds and hundreds of followers. eBay has unleashed tens of thousands of people to be entrepreneurs. Yahoo store has done the same thing. So has Craigslist. Even if you're not a technologist, the barriers to entry keep getting lower and lower.

From a technology perspective, you have two billion lines of open source code. We funded a company called 1-800-FREE411 that needed to build lots of telecomm infrastructure. At first, when they were scoping it out, it was a daunting task until one of them looked at open source and found a project called Asterisk, which is basically an open source PBX. They had it up and running in two weeks and it cost them nothing. It's just astonishing. With each cycle of technology, you're improving the foundation for the next generation of entrepreneurs and you're lowering barriers to entry. What I'm optimistic about is that while entrepreneurship is always risky and there's always a high chance of failure, both in terms of raw dollars and time, costs keep coming down to the point where more and more people are encouraged to try.

What am I concerned about? Right now the venture model isn't aligned with current market realities. It's not aligned in terms of capital efficiency of companies or in terms of exits. Paul Kedrosky of the Kauffman Center just authorized a study noting that half of all existing venture firms should not exist. My sense is that most VCs agree but think they're in the half that should exist. It's not just a problem for VCs but also for entrepreneurs: there's so much money out there to deploy that entrepreneurs who only need $2 million are pushed instead to take $8 million for 20% of a company. There's an unwritten rule on term sheets that says you need to get a good economic return for that last investor. If your post money [valuation] is raised really high because you have to absorb all of this capital, your exits get cut off.

Seventy-five percent of all venture-backed M&A in the last seven years occurred at a price of $150 million or less. If you lock into a post-money valuation of $50 million, VCs are not going to be happy with a $150 million return because it's only 3X, and that's not what they're playing for.

I go to New York all the time, and I can take one of two trains. They both go to Penn Station, but one's local and one's express. Part of the challenge is when an entrepreneur takes capital from a big fund, she's unknowingly buying an express ticket to a $1 billion IPO, because that's what moves the fund's math. The fund needs to create $7 billion worth of market value. If this is only a $250 million exit, we're talking maybe 5X. Thirty more of those? That's hard to do.

When you take that big ticket, you're buying the express ticket. It's sometimes not until after the train's left the station that entrepreneurs realize, "Uh - oh, I just bought the express ticket." What I like about more capital-efficient funded companies is that they stay on the local train. Now let's be clear, the goal of the entrepreneur and the VC is to reach the same destination. You're still buying a ticket to Penn Station, and when the doors open in Trenton or Newark, at that $25 million stop or $75 million stop, you can look around and say, "Is there smoke on the train, should I be getting off, what's happening competition-wise?" That gives you optionality. The challenge is not merely VC funds overpaying. There's pain caused by entrepreneurs who are unwittingly being sold the express train ticket, which takes away a lot of the optionality around exit in today's market.

Chris. I'll edit one thing you said, that the doors open and you can see if there's smoke on the train. You can also see that a stop like Princeton Junction is a nice leafy suburb…

Josh. Oh, sure. Any company that's going to exit for $1 billion has to have the self-confidence to turn down a $50, $100, and $500 million offer. In some cases, it's not self-confidence. In some cases, the right thing is to exit at these lower valuations based on your knowledge of the business, its revenue traction, order pipeline, management team, and so on. What ends up happening is it turns into this moon shot where you either reach the stratosphere or you don't. To be clear, I don't buy tickets to Princeton. I'm not investing in a company because I think aspirationally it could be a $50 million company. We're still buying tickets to Penn Station, but we like having the optionality to exit if a company doesn't reach truly lofty heights.

Chris. If you could wave a magic wand and do something to improve the venture industry's odds of making an impact on the quality of people's lives, what would you do?

Josh. I'd draw attention to the exit math we discussed earlier. At present, we're in a down market, but even in 2007, where there were roughly 70 IPOs, those deals raised just $6.8 billion. I'd make sure that everyone here actually looks at the underlying math of our industry. The irony is that overcapitalization doesn't just hurt performance, it lowers the chance of success because you have companies that are locked into trajectories they otherwise wouldn't be locked into.

Venture firms do a great job of differentiating themselves. They have to. I don't think anyone's afraid of competition. You're going to win some deals, you're going to lose some deals. But the whole concept of venture as an asset class is relatively new. As a result, you have a generation of general partners that have never earned and probably might not ever earn a carry check. This has transformed motivations and alignment, and the best hope the VC industry has is when GPs' and LPs' interests are aligned.

Chris. Switching gears, who's been your role model and why?

Josh. My grandfather. He came back from World War II and founded a company called General Transistor, which he sold to General Instruments. He was one of the LPs in Art Rock's first fund, and then he set up a venture fund. I admired his entrepreneurial career; however, what I admire most about him is his generosity, his humility, and his understated approach to things. I've learned a lot from him. He's not a talkative person, so I typically find car rides are the only time to have really good conversations with him. As a side note, I find the same thing with my kids. I have the best conversations with my daughter when she's trapped in the back seat of the car and there aren't distractions like TV!

My Grandfather tells the story of his uncle, who was pretty affluent. When his uncle was dying, he gave gifts to all of his nephews and nieces, including my grandfather. My grandfather was successful at the time, so his uncle gave him a list of charities he wanted him to support. I think he told me that story because I should expect a list!

Chris. Another favorite question at TEF seminars: what's the most memorably impressive display of grace under pressure you've witnessed in real time?

Josh. I co-founded my first company, Infonautics, when I was a sophomore in college. By the time I graduated, we had 20 employees. We went public two years later and hired a CEO. I learned an unbelievable amount from him. I remember the road show for our IPO.

I was meeting the team in the Bay Area. I flew out separately, so I missed the limos. I went to rent a car, but I was 22, and all the rental car companies have an age limit of 25. I had to stop and realize that I was going on a road show to ask people to trust me with tens of millions of dollars to take this company public, and I couldn't get Hertz to trust me with a car! That's not grace under pressure, but rather a funny side story! We did the first meeting, and I blew it. This was a big institution that could have absorbed the entire offering on its own, and I just blew it. Our CEO had every right to rip into me. Instead, he said, "You know, if you're a basketball coach and you have a star player, and your star player fouls out in the first five minutes of the game, any coach is going to say, 'You're playing too hard.' On the other hand, if you play five games and your star player doesn't get any fouls, a good coach should say, 'You're not playing hard enough.' You should encourage people to take chances and get their fouls."

The culture that motto builds is something I've tried to nurture in all of my companies. I've seen large companies that build a get-no-fouls culture. They build a culture where you might have that wild and crazy idea but you don't want to take the chance because the downside risk of being wrong is too great. The way that's demonstrated is the first time someone takes a chance and is wrong, the CEO cuts their legs out from underneath them. That sends a message to the entire organization. In 1999, we were trying to launch Half.com, but we didn't have a marketing budget. Our marketing team couldn't think of anything creative. I wanted to do something big that would really put us on the map, and we spent six hours brainstorming. Finally, our VP of marketing got so angry with me he said, "You want to get on the map? You should just find a town and change its name to Half.com; that will put us on the map." And we all kind of looked at each other and said, "Wow, that's a really good idea." So we went to Google and searched "Half," and Half Moon Bay has a population of a million people, which was too expensive. But we found Halfway, Oregon, 345 people. The next day we had three people go out there to meet with the mayor, and we convinced Halfway, Oregon, to change its name to Half.com. It got us on the Today show, which set us on the right trajectory. We got $10 million worth of PR. That came as a result of creating a culture of getting fouls. The story continues: we were talking at a Chinese restaurant about *The New York Times Book Review*, which would cost us about $30,000 a week for advertising. So we said, look, everyone reads their fortune. What if we could get an ad on the back of the fortune inside the fortune cookies at Chinese restaurants? The next day, we were at Won Ton Foods, which makes half of all fortune cookies sold in restaurants in the US. We had "Save a fortune at Half.com" and put a coupon on it, and that was our single best source of customer acquisition for a year.

But before we had that idea, we had a foul. I'm going to use a couple of words that have never been used at a TEF Seminar: urinal screens. If you look at urinal screens, which are there to block cigarettes from going in, there's typically a phone number you call to replace them. Our colleague said, "What if on the urinal screen we printed, 'Don't piss away half your money, shop at Half.com!'?" He then went to Wharton and hired five interns for hands-on viral marketing and handed them gloves and told them to go out and insert these things at every train station and airport. What we didn't know was, you know, these things never get changed, so they're out there for years. I had investors calling me up after we were acquired by eBay saying, "My board member just told me he pissed on my brand."

Again, if we had a no fouls culture at Half.com, we never would have run with the fortune cookie idea. I think the greatest display of grace under pressure, tying it all back in, that I personally saw was the way my own CEO turned my foul into a learning moment for me. Yes, I was wrong, I made a mistake, but the way the CEO handled it helped shape the type of culture I strive to create in all of the companies in which I'm involved.

Chris. Great story, Josh. Thank you very much. ■

Hold the Date!

TIFF Education Foundation Endowment Management Seminar Boston, Massachusetts November 4, 2010

In furtherance of its mission of promoting the dissemination and adoption of best practices in endowment management, the TIFF Education Foundation (TEF) will conduct a seminar on Thursday, November 4, 2010, at the Boston Public Library. Due to space constraints, we cannot guarantee admission to all interested parties but will do our best to accommodate qualifying applicants. Registration details to follow in the coming weeks. We hope you'll be able to join us!

Confirmed Interviewees

David Dominik
Managing Director
Golden Gate Capital

Ken Hersh
Managing Partner
Natural Gas Partners

Miles Morland
Chairman
Development Partners International and
Blakeney Management

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