Increasing Credibility of Future Returns in VC Investments

Venture capital groups investing in promising start-ups hope to promise their investor community a high future rate of returns. At the same time, their investor community is counting on the estimated returns to be credible. The problem is that, in the VC industry, advertised returns are speculative until the investment is publicly traded.

Recent industry studies tell the story. With only 23% of companies that receive first round funding going to IPO, and investors waiting more than four years (on average) to realize any return on their investment in the companies that do go public, it is easy to see why most advertised future returns lack credibility.

Analysts say that 77% of all estimates of future returns are found to be incorrect for early stage investments. And when the estimates are wrong, it is because they were overestimated.

These same studies report that late stage investments fare better. Late stage (fourth round) investors wait only 1.5 years (on average) for an IPO, and 47% of investments funded go public. Although fourth round risks are lower than first round, credibility of future returns in late stage investments are over-estimated 53% of the time.

Add to this studies that show that, on average, 30% of all IPOs account for 70% of the revenue generated by VC backed firms and it is clear that however large the potential jackpot may be, as an investment strategy, pre-IPO investments are some of the most risky business ventures offered.

How soon an IPO occurs and how much return is realized depends many factors. Included among these are the maturity of the target company at the time of investment, the thoroughness and quality of the due diligence process by the VC management team.

Rate of return and time to return have also been shown to be influenced by the culture of the start up. In the privacy of their offices, many VC management teams identify culture issues as one of the main reasons many promising start-ups never reach the IPO stage. Some start-ups refuse to “grow up”. Others cannot sustain innovation and agility. Still others refuse to enter new markets, integrate new technologies, or adopt industry best practices for operations or management.

CURRENT WAYS TO REDUCE RISK

To increase the success rate of IPOs, some VC groups are turning to traditional change management techniques as a means to shepherd their fledgling organizations into maturity. The goal is to help future stars rise quickly through each stage of maturity by managing the “people side” of growth.

Change management is useful for human factors activities such as defining vision, mission and value statements, team-building, empowerment, creating new processes and training. For that reason, traditional change management can fill an important role during the growth of a start-up.

Unfortunately, traditional change management techniques are not designed to identify, address, and eliminate the inbred culture issues that can stunt the growth of start-ups. Nor do they reliably anticipate and quantify the influence of a start-up culture on future performance of the start-up company, or prevent a disastrous culture melt-down at later stages.

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IMPROVING THE ODDS

Corporate culture is never static. The culture of a start-up grows and matures in the same way as the capabilities of the organization and its leadership team matures.

And as the company matures, culture issues that may be undetected during first-stage due diligence tend to emerge at later funding stages. When culture issues do arise, they hamper growth or lead to unintended (and often detrimental) consequences that undermine the potential of the company and delay the IPO.

Of course, a VC can always flip a disappointing investment. But flipping is a time consuming, sometimes costly process. Far better to avoid funding "dead beats" in the first place. To avoid culture issues that can threaten the success of a deal, the VC team should pay close attention to the culture of a startup during due-diligence activities.

INCREASING ACCURACY OF ESTIMATES

The best way to increase the accuracy of future returns is to increase the odds that a start-up will perform brilliantly after it goes public.

And the best way to increase those odds is to have the "deal guys" perform a culture audit during the due diligence process and define a strategy for maturing the culture.

The best culture audits and maturity strategies:

- Are **fast** and add no additional time to the due diligence process
- Are **non-intrusive** and don't interrupt the daily activities of the target company
- Provide a **statistically valid culture profile** of the target company
- **Identify existing and pre-emergent culture issues** ranked by risk
- Offer a game plan that, when implemented, **eliminates each high risk issue** that emerges as the start-up matures
- **Decrease time to IPO** by suggesting ways to leverage the culture assets of the start-up
- Identify whether the culture of a start-up **appears to be incompatible** with the VC experience or unable to hold-up under the pressures of public trading
- **Respect confidentiality** of the VC Group, the start-up, and the audit report (although this should go without saying)

BEEFITS OF CULTURE AUDITS AND MATURITY STRATEGIIES

A pre-investment culture audit and maturity strategy helps **reduce management, development, and operational cost** through early identification of culture risks. Implementable strategies provide shortcuts around known culture issues, in addition to **shorter time and less fallout prior to IPO.**

Tangible benefits of a culture audit include:

- **Increased accuracy on estimates of future return** resulting from more exact financial and timing estimates

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- **Increased speed** of business development
- **Avoidance of unintended culture consequences** as the start-up progresses through each growth phase
- Opportunity for **increased post-IPO performance**, superior innovation ability, and agility

Conclusion

Pre-emergent culture issues present at start-up impact the success of a VC investment more than most deal-makers are prepared to admit

Traditional change management approaches used by some VC's are not designed to identify risks related to culture during the due diligence process. They cannot remove culture issues as the start-up matures, nor they do increase the rate of future returns by ensuring high post-IPO performance

A statistically valid culture assessment performed during the due diligence phase is a low-cost investment that can increase future returns by disqualifying high risk start-ups and providing a maturity strategy that enables qualified start-ups to grow rapidly and efficientlyinto an IPO —without debilitating culture issues.

About Change Delivery Group

Change Delivery Group provides culture audits and maturity strategies based on proven scientific methods. If you are investing in a start-up and want to reduce your risks, contact us early in the planning phase at 303-523-5541. We are committed to help you maximize the return on investment for your group and your partners.

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