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THE FORMAL AND INFORMAL VENTURE CAPITAL INDUSTRY

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ABSTRACT

This article examines the nature and activity of the formal and informal venture capital industry. Combined, there is a pool of nearly $100 billion in formal and informal venture capital in this country that is available for investment in emerging growth businesses. Although traditionally venture capital investments were targeted to early stage – and often "high tech" – companies, there has been a growing tendency on the part of venture capitalists to invest in "low tech," later stage businesses as well as in LBOs. This article also examines the criteria used by venture capitalists in making investment decisions.

INTRODUCTION

Most of us have heard of such names as Kleiner, Perkins; Hambrecht & Quist; Warburg, Pincus; and Hillman Ventures, yet we may know little about these venture capital firms or about their industry. We know that they invest in some emerging growth ventures. But, how actively do they invest? What are their typical investments? How do they make investment decisions? Finally, aside from the "formal" venture capital firms, what is the impact of "informal" venture capital investments on entrepreneurial development? These are the issues addressed in this article.

THE FORMAL VENTURE CAPITAL INDUSTRY

Venture Capital Firms

The formal venture capital industry in the United States is characterized by several hundred venture capital firms. These firms, which are also referred to as "venture companies," "venture firms," "venture funds," "venture partnerships" or "venture capital pools" resemble mutual funds, to some extent in terms of their investment activity although not in terms of their investment philosophy.

Structure and fee arrangement of venture capital firms. The venture capital firms are usually structured as limited partnerships with a group of investors, called "limited partners," and a group of managers of the fund, called "general partners." They share in the profits in ratios disproportionate to their capital contribution. Typically, the general partners, who manage the portfolio but do not necessarily invest in the ventures themselves will usually receive a percentage of the profits plus an annual management fee. Management fees alone can amount to 20% of the total capital raised over the life of a fund. For example, E. M. Warburg, Pincus & Co. will receive over $200 million in management fees alone for managing the $1.2 billion fund it raised in 1986, if the fund is in place for its full lifetime.[1]

Although the fee structure can often be justified due to the tremendous amount of time spent by the general partners in researching their investments and in assisting the entrepreneurial companies on matters related to long term growth, there is always the fear that as the funds grow larger in size, venture capital firms may become driven primarily by management fees, rather than by the potential profits of their investments. Obviously, the size (i.e., percentage) of the management fee was very appropriate with funds in the $10 million to $50 million range. However, as the funds have grown so large (i.e., in the hundreds of millions of dollars and upwards), the limited partners are beginning to question the fee structure.

Venture capital firms vs. mutual funds. Clearly, the investor-fund manager-investee situation for venture capital investments is far different than it is for mutual fund investments in publicly-held companies, in which the research demands by the mutual fund manager are far less and the managerial assistance demands are virtually non-existent. As noted by Bruno et al. (1985) and by Gorman & Sahlman (1986), venture capital investments are more than monetary; the venture capitalist serves as a "resource manager" to the emerging growth businesses by providing them with assistance on such issues as recruitment and planning. As noted by John Pappajohn, President of Pappajohn Capital Resources in Des Moines, Iowa, "I'm really in the business of putting together good ideas and good people with money, of financing companies at start-up and then keeping close tabs on them until they go public" (Kravitz, 1985, p.11).

Although venture capitalists are unlikely to get involved in the day-to-day operations of the business, they will often get involved in strategic planning, marketing, and other long range issues. Pappajohn, who plays an active role in companies in which he invests, adds, "I call them every day and I make them millions."

Time demands of venture capitalists. Of course, some venture capitalists have a different view of the process; they find themselves devoting more time to raising capital from investors than they do to assisting the ventures in which they invest. This has been more evident among venture capital firms that invest in early stage ventures, which spend a large portion of their time fund raising for subsequent rounds of financing; it becomes even more pronounced during periods of stock market declines, at which time there are fewer IPOs.

We have used the term "venture capital firms" very broadly to include not only the traditional venture capital limited partnerships but also the publicly-held venture capital companies, which are called "business development companies" (BDCs), small business investment companies (SBICs), venture capital subsidiaries of larger corporations and so forth. We are referring to any of these managed pools as a "venture capital firm," a "fund," a "partnership," or a "pool." Furthermore, once the venture capital firm makes an investment in a company, it is the venture capital firm rather than the limited partners which is referred to as the "investors."

The Size of the Venture Capital Industry

A decade ago the venture capital industry's total capital under management was approximately three to four billion dollars. Today the pool is approximately 10 times that size. Currently there are over 2,000 professionals in the "formal" venture capital industry as compared to about 600 in the late 1970's; they work for more than 600 formal venture capital firms (including SBICs and venture capital subsidiaries of larger corporations).

The size of the individual venture capital firms. A decade ago the largest venture capital firm was about $40 million, and the average fund was approximately $15 million. In 1982 the

first of the "mega-funds" (i.e., those with paid-in capital of $100 million or more) was created when Kleiner Perkins Caufield & Byers raised $150 million. Today the mega-funds are commonplace with several of these funds (such as Warburg Pincus, Hambrecht & Quist, John Hancock Venture Capital, First Chicago Venture Capital, TA Associates), each having over $½ billion in paid-in capital.

Venture capital firms are becoming even larger. In 1990 Warburg, Pincus completed a $1.8 billion venture capital fund which not only dwarfed its previous $1.2 billion fund but also was three times the size of any other venture capital partnership at the time. This is indicative of the trend towards larger venture capital funds that has emerged over the past few years.

In recent years the large venture capital firms have gotten larger, partly because of the larger investments of pension funds. Such investments by pension funds, however, have been very selective; the pension fund managers, in keeping with their fiduciary responsibility and their aversion to risk, have primarily invested in the larger, more diversified, more established venture capital firms.

Of course, the "rules" of the venture capital game have changed as the stakes have gotten higher and as the funds have increased in size. In some cases heavy institutional investment has been detrimental for the industry. For example, some of the large institutional investors have put pressure on venture capital firms to take the venture capital-backed companies public too soon. By shortening the time from venture capital funding to IPO funding from five or six years to two or three years, investors can get their money out sooner. However, this often upsets the normal growth pattern of the venture capital-backed company, thereby making it vulnerable in the process. Moreover, this is often in direct conflict to the philosophy of the role of venture capital firms in "building companies." Nonetheless there have been numerous positive results, as evidenced by the successes of such venture capital-backed companies as Apple Computer, Compaq, Federal Express, Digital Equipment and Tandem.

Amount of capital raised by venture capital firms. One measure of the growth of the venture capital industry is the amount of money raised each year from investors – that is, the limited partners (wealthy individuals and families, pension funds and corporate investments).

In 1977 the venture capital industry raised a total of $39 million. Since that time there has been a significant but fairly steady increase in funds raised by venture capital firms. According to *Venture Economics*, which tracks such statistics, it reached $1/2 billion in 1979, then increased to $2 billion in 1982 and to $5 billion in 1987. Since that time, however, due to market conditions and several other factors, there has been a significant *decline* in the amount of money raised by venture capital funds in a given year to about $3 billion in 1988 and to less than $1 billion in the most recent year. As noted earlier, the total pool that has been raised is in excess of $35 billion.

Nature of Venture Capital Investments

Once the funds are raised, what kinds of investments are made by venture capitalists? Throughout the 1980s computer hardware and systems companies were consistently the largest recipients of those investment dollars. This has been reflected by their relatively large representation (generally 30-40%) on the *"Inc. 100"* list, which is a listing of the fastest growing, small *publicly*-held companies in this country, most of which have gone public within the past few years. That situation has begun to change somewhat in recent years, since service businesses,

such as consumer-related/retail and health care have received a greater portion of venture capital funding than the computer and related companies; a similar pattern is seen among the *"Inc. 500"* list, which is a listing of the fastest growing, small, *privately* held companies in this country. (The *"Inc. 500"* companies, which are privately held, generally are smaller, earlier stage ventures than the "Inc. 100" companies, which are *publicly* held.) Moreover, recently there has been a trend among venture capitalist towards greater specialization by industry (Bygrave, 1987) and by geographic location (Libecap, 1986); two of the emerging trends have been in "low tech" businesses and leveraged buy-outs [LBOs].

Geographic concentration. As may be expected, venture capital firms are regionally concentrated in this country with the greatest number located in and around New York City (which has about one-third of the largest venture capital firms), San Francisco/ Silicon Valley (15% of the venture capital firms), and Boston (15% of the venture capital firms). Of the 100 largest venture capital firms in this country, two-thirds are located in just three areas; this suggests an extremely disproportionate distribution of venture capital firms throughout the nation.

The three leading states in which venture capital firms are located, New York, California, and Massachusetts, are also the three leading states in which venture capital funds are disbursed, however, not in the same order.

California. The greatest number and the largest dollar value of venture capital commitments are in California. This should not be surprising since California has produced the greatest success stories among entrepreneurial companies over the past decade. Specifically, since 1980 or so California has had 21 companies – including Sun Microsystems (Mountain View), Businessland (San Jose), AST Research (Irvine), Softsell Computer Products (Inglewood), LSI Logic (Milpitas), Maxtor (San Jose), Everex Systems (Fremont), and 3 Com Corp. (Santa Clara) – go from start-up to the $100 million level in revenues in fewer than 10 years; no other state has had more than five.

California venture capital firms have made significant investments in high tech industries over the past two decades. Hambrecht & Quist (San Francisco), Sierra Ventures (Menlo Park), Sequoia Capital (Menlo Park), and Kleiner Perkins Caufield & Byers (Palo Alto) are some examples of such venture capital firms that have invested heavily in high tech companies in the Silicon Valley area. There are over two dozen venture capital firms which specialize in high tech investments in a single location in Menlo Park. They are located in a complex at 3000 Sand Hill Road, which has become known as one of the leading high tech starter locations in the world.

Over 75% of the venture capital investments by California venture capital firms remain in the state. In addition, entrepreneurial companies located in California receive a substantial amount of venture capital from other states. Thus, California is a "net recipient" of venture capital.

Massachusetts. After California, Massachusetts companies have been the next biggest recipients of venture capital. Similar to California, there is a high tech focus among many of the venture capital firms in Massachusetts, especially those located around the famous Route 128 near Boston. Combined, companies in California and Massachusetts receive about 50% of the total dollars invested by venture capital funds in this country.

New York. There are several dozen venture capital companies located in New York, with the majority located in New York City. Many of the New York City based firms have links with financial institutions, such as commercial banks (for example, Citicorp, Irving Trust, Chase Manhattan) and investment companies (for example, Merrill Lynch, Salomon Bros., Donaldson Lufkin Jenrette). New York is a "net provider" of venture capital; more than 80% of the investments of venture capital firms based in New York go to companies located outside the state.

Other regions. In many ways the venture capital climate in Illinois is similar to that of New York. Many of the venture capital firms in Illinois are linked to financial institutions (for example, First Chicago Venture Capital Company, First Capital Corp. of Illinois, Continental Illinois Venture Corp.).

Other regions have been prominent in the venture capital area. Texas has historically funded energy related companies. This has resulted in problems due to the recent slump in energy prices. Minnesota has had its share of technology investments by venture capital firms located in that state. A good example is the funding of Control Data Corp. (Minneapolis, MN), which spun off from the Sperry UNIVAC project in the 1950s and which later gave rise to Cray Research. Control Data has since become an investor in early growth technologies, as was the case with its acquisition of VTC, Inc. (Bloomington, MI), which manufactures high performance integrated circuits. (More recently, Control Data sold 80% of VTC, which was unprofitable, to privately held Seattle Silicon.)

Locations for business growth. The data on locations of venture capital investments provided above should not be surprising since it parallels somewhat the locations of business growth in this country. Out of the 500 fastest growing, small private companies included in each of the recent *"Inc. 500"* lists, the greatest number has been in California (which had 84 in the most recent listing). In each of the last few years California, New York and Massachusetts have been among the six states with the largest number of *"Inc. 500"* companies.

One point is critically important when it comes to location: although the data just presented may suggest that location can dictate the success of the financing effort of a company, it is the quality of the company rather than the city in which it is located that will ultimately determine the future success of the venture. (See the last section of this article on "How Venture Capitalists Make Investment Decisions.")

Investments based on stage of development. Over the past decade there has been a decrease in the relative level of investment in early stage ventures with a corresponding increase in the level of investment in later stage ventures and LBOs. For example, in 1983 start-up ventures represented 27% of the investments of the "100 largest capital venture firms in this country" or more than double their current amount, and LBOs represented 14% of their investments or less than half of their current amount. The change in LBO investments during that time has been dramatic, especially from 1983 to 1988, when there was a nearly five-fold increase from $280 million to $1.32 billion.

What prompted this change in investment philosophy? One of the reasons for this change in investment philosophy is the size of the venture capital funds. As several of the funds have increased in size to the hundreds of millions of dollars in paid-in capital, the trend has been away from start-ups in favor of more established companies.

This should certainly not imply that *all* large venture firms have abandoned start-ups. For example, E. M. Warburg, Pincus & Co., whose $3.4 billion in paid-in capital easily makes it the largest venture capital firm in this country, has always made its investments in three distinct types of situations: undervalued assets, developing/expanding companies, and start-ups. The company uses the following framework to balance the risk/reward levels of these three types of investments: (a) undervalued assets represent 50% of the fund's dollars of capital but only 20% of the number of deals; (b) developing/expanding companies--35% in terms of dollars and 30% in terms of number of deals; and (c) start-ups--10-15% in terms of dollars and 50% in terms of number of deals.

Certainly, Warburg, Pincus has not abandoned start-ups, as evidenced by the $180 million it invested in 51 start-up situations over the past decade. The result of this investment philosophy has been quite appealing to the limited partners of Warburg, Pincus. The firm had a 25% compounded annual return for its investment portfolio over a 20-year period from the time it was formed in 1971 through the end of the decade of the '80s. Thus, the trend away from start-up investments has been more evidenced by the *dollars invested* than by the *number of deals* funded by the venture capital firms. As noted by Frederick M. Haney, of 3i Ventures in Newport Beach, California, "When you have that much money, the tendency is to put it out in large chunks. Very little is likely to go to early stage companies" (Gupta, 1989).

Nonetheless, many of the larger venture capital companies are investing more actively in later stage investments, particularly in LBOs and less actively in start-ups. Many "purists" in this industry are quite upset by this evolution in investment philosophy. Certainly, a strong case can be made in support of LBOs, as evidenced by the creation of jobs, economic gains through increased taxes and so forth. However, the typical argument against funding LBOs – and often rightly so – is that the process has resulted in many venture capitalists' becoming strictly investors rather than investors/advisors. This clearly runs counter to the classic philosophy of venture capitalists whose objectives were clearly to build companies.

LBO investments. Venture capital firms, even the "traditional" venture capital firms, are investing increasingly larger percentages of their portfolios in LBOs. Bain Capital of Boston, for example, which is well known for its early stage investment in Staples, a Newton, Massachusetts based retailer of office supplies, has earmarked more than 75% of its recent investments for buyouts. Several other venture capital firms, which were formed with the intent of funding early stage ventures, invest either primarily or exclusively in LBOs. The leading investors in LBOs among venture capital firms include First Chicago Venture Capital, Boston Banc Capital, Schroder Ventures, Security Pacific Capital, Manufacturer's Hanover Venture Capital and Chemical Venture Partners.

It should be noted that even though venture capital firms are investing more in buyouts, they will often assist management in the same way as they do for early stage ventures; in that way, they *are* building companies. For example, Hambro International, a New York-based venture capital firm, recently invested $3.6 million in the buyout of Building Technologies Corp., a manufacturer of metal building systems, from Southwestern General Corp. (Cincinatti, OH). Hambro also raised another $40 million in a combination of straight debt and subordinated debt. It is Hambro's plan to work with management over the next few years to streamline the company and to expand its markets.

Of course, in some cases, venture capital firms have virtually ignored the newer, smaller companies in their portfolios, which can become even more prominent as selected investments

in LBOs and later stage ventures become even larger. For example, consider the case of an early stage "high tech" manufacturing company in New England, which was recently able to raise nearly $1 million from a leading venture capital firm located just a few miles from the company. Unfortunately, the amount raised represented less than 1% of the venture capital firm's paid-in capital, with the vast majority of its investments being targeted to later stage ventures and LBOs. Despite the fact that the venture capital firm is represented on the company's board, the company claims that it has received very little from the venture capitalists other than a "large check to help scale up production."

THE INFORMAL VENTURE CAPITAL INDUSTRY

"Angels"

The structure of the formal venture capital industry, which includes the major venture capital firms which raise money from investors and invest in growth-oriented companies, is fairly well defined. However, recently, many entrepreneurs have sought funding from "angels," wealthy individual investors who are most interested in providing capital to start-up businesses.

The notion of "angels" is nothing new. After all, in 1903 Henry Ford's automobile company was started partly as a result of five angels who invested $40,000 in the venture. The idea is commonplace today. Countless ventures get their start through the funding by such angels. For example, when Ben Bush of St. Petersburg, Florida launched Brass Letters & Logos, Inc., he relied on personal contacts (as well as self funding) for the necessary start-up capital. The company used the capital to enhance its manufacturing process and to expand the distribution network for its merchandise. (Brass Letters was recently acquired by a large distributor.)

Angel networks. Angels, which are also referred to as "adventure capitalists," can be found in private clubs throughout the nation. Joseph Mancuso, director of the Center for Entrepreneurial Management in New York, has organized "angel" chapters in several large cities. In addition, Professor William Wetzel of the University of New Hampshire has developed the Venture Capital Network (VCN), a computerized database to link entrepreneurs with investors.

The Impact of "Informal Investors"

According to Wetzel (1988), who is the leading researcher in this country on informal investors, if institutional venture capitalists finance fewer than 1000 start-ups annually, where do the other 24,000 (give or take a few thousand) find their equity capital? Wetzel suggests that informal investors probably fund 20 times more ventures than do established venture capital companies. Frank Swain, chief counsel for advocacy of the Small Business Administration (SBA), reported in a recent issue of the *Journal of Accountancy* (1988) that self funding and informal investments account for 75% of all equity investments in small business.

A Large Pool Available For Start-Up Capital

Wetzel indicates that there may be as many as 250,000 informal investors (as compared to the approximately 2,000 formal venture capitalists) in this country, responsible for a $50 billion pool of venture capital (as compared to the $35 billion pool of formal investors). Moreover, as suggested by Gaston (1989), who was commissioned to do a study for the Small Business Administration (SBA), informal investors are the major sources of start-up capital, investing approximately $27 billion per year, primarily in start-up deals.

As indicated earlier, established venture capital companies have been devoting a larger portion of their portfolios to later stage investments at the expense of start-ups. That has made informal investors prime candidates for the funding of early stage ventures; in fact, the informal investors tend to favor the early stage investments over later stage ones as they feel they can get involved in the growth of the company as early as possible, as noted by Seymour & Wetzel (1981) and by Brophy (1982), informal investors, who are often the financial backers of technology start-ups, are often interested in funding the following ventures: (a) which are seeking approximately $20,000-$50,000 in start-up capital; (b) which are in close proximity to where they live; (c) in which they can also play an active consulting role; and (d) which are appealing in terms of product features and potential returns.

HOW VENTURE CAPITALISTS MAKE INVESTMENT DECISIONS

The Nature of the Venture Capital Investment Decision

The classic study involving the "modeling" of the venture capital decision process was conducted by Tyebjee and Bruno (1984). The model describes the following sequential process of venture capital investment activity: (a) *Deal Origination*--by which deals enter into consideration as investment prospects, some of which, particularly technology ventures, are actively sought by investors (Timmons & Bygrave, 1986), but most of which enter into contention via the referral process; (b) *Deal Screening*--in which prospects which are likely to number over 1000 per year for an established venture capital company are narrowed down in series of stages to a few for in-depth evaluation; (c) *Deal Evaluation*--in which prospects are evaluated based on their relative levels of perceived risk and expected return; (d) *Deal Structuring*--which describes the negotiation for equity position; and (e) *Post Investment Activities*--which includes management recruiting, strategic planning, locating expansion financing and assisting in the "cash- out." According to Bruno and Cooper (1982), more than 50% of such ventures that go through the formal venture capital process are likely to either go public, merge, or be acquired.

Factors Considered By Venture Capitalists When Making Investment Decisions.

Researchers have also examined the factors considered by venture capitalists in funding entrepreneurial ventures. The study by Tyebjee and Bruno just noted found that venture capitalists make decisions regarding funding of ventures based on product market attractiveness, product differentiation, management capabilities, resistance to environmental threats, and cash-out potential. Several practitioner books and articles dealing with securing venture funding provide support for this research (e.g., Mancuso, 1985; Rich & Gumpert, 1985; Schilit, 1990).

Factors Considered To Be Most Important.

The "popular" books and articles noted above all stress the importance of management in securing funding. This is consistent with the research of MacMillan and his collagues (1985), who found that the two most important factors considered in the funding process were management related – the entrepreneur's staying power and the entrepreneur's familiarity with the target market. Furthermore, they found that five of the 10 most important criteria in determining funding were related to the entrepreneur's experience or personality.

The Likelihood of Receiving Venture Capital Funding.

Consistent with the popular notion of the difficulty of obtaining venture funding, Maier

& Walker (1987) found that fewer than 5% of the proposals received by venture capitalists were funded. Therefore, we would expect that entrepreneurs would have to look elsewhere for funding. This is supported by a recent study conducted by the National Federation of Independent Businesses [NFIB], which found that 72% of new businesses get at least part of their financing from friends and relatives (Bartlett, 1986).

Turning On Investors

Due to the riskiness of the venture business (only a limited number of investments provide adequate returns) investors set rigorous standards in evaluating venture proposals. A large majority of proposals are rejected, due either to the nature of the product or service, the quality of the business, the capabilities of management, or the preparation of the business plan itself.

There are several specific guidelines to follow in order to "turn on" investors. This necessitates that the entrepreneurial team demonstrate the following four features: (a) a clear definition of the business; (b) evidence of marketing capabilities; (c) evidence of professional management; and (d) an attractive financial arrangement.

Definition of the business. There are three basic questions regarding the business that, when answered, provide a working understanding of the definition of the business this is also known as the mission or scope of operations of the business (i.e., what business are you in?; in other words what is the product or service? what is the industry? what is the target market?).

No small business venture can be "all things to all people." Thus, in the earliest stages of a business it is critical that the company develop a logical, somewhat stable business definition or strategy and avoid any dramatic changes to it. Any alteration of one or more of these three features – the product or service, the industry, or the target market – results in a new and riskier strategy for the firm. Of course, as the business expands, the only way to accomplish significant growth will be to alter its current business definition, whether by expanding the product line, entering a new industry, or seeking a new market for a given product or service. Investors, however, will want to see some initial stability in the company's strategy or business definition.

Marketing capabilities. A company's marketing capabilities are evidenced by the product's benefit to the user and by its marketability. Demonstrating user benefit will necessarily strengthen the entrepreneur's contention that the company can generate sales and will, therefore, be an attractive investment opportunity. Benefits to the user vary considerably from product to product. However, there are a few guiding questions to demonstrate this characteristic: Will the product save the customer money? Will it save time? Will it provide status? Will it enhance the customer's lifestyle? How long will it take to pay for itself?

Even if the product has benefit to the user, a critical question is whether enough customers will buy it. A well recognized market can certainly enhance the likelihood of obtaining funding. Investors generally want to see some indication that customers or clients have used the product or service – even if only on a trial basis (for example, a prototype) – and are happy with it. Obviously, the best indicator of whether there will be customers in the future is if the business has had customers in the past.

As a general rule, most investors prefer to fund companies with some operating history (this provides some assurance of success) although it is not necessary that the venture be operating profitably. Stated another way, investors would prefer to have their money used for production and selling, rather than for product development and market research, thereby reducing the risk and accelerating the time span for profits to be generated.

Professional management. Investors would much rather fund experienced managers who can work together as a managerial team than sole entrepreneurs. The management team should have a demonstrated track record and competences in each of the critical functional areas – marketing, finance, product design and production, control, and personnel. Investors generally agree that the most important factor in evaluating a venture capital opportunity is the management of the company. Investors will almost always prefer a first rate management team with a second rate product over a first rate product with a second rate management team.

Financial arrangement. Investors prefer to see a structured arrangement presented by the entrepreneurial team which describes the capital needs of the venture and which proposes a fair equity agreement for the two parties involved. Investors maintain a time horizon of five years (or a range of three to seven years) in which to realize their returns on their initial investment. During that time period, they expect their investment to increase in value by 5-15 fold, net of inflation.

What dictates the return on investment expected by a typical investor? Essentially, it is based on the riskiness of the investment. Thus, the higher the riskiness of the investment, the greater the expected return for the investor.

Riskiness is generally based on two factors which were discussed earlier: (a) the nature of the product or service; and (b) most importantly, the quality of the management of the venture. Newly developed ideas are more risky than established products or services; investors generally wish to see products or services that are already being used and have been accepted by customers. (Having exclusive rights to a product or process via copyrights or trademarks, however, will make even a new product seem attractive in the eyes of the investor.) Similarly, individual entrepreneurs are seen as more risky than are established management teams.

CONCLUSION

We examined the nature and activities of the formal and informal venture capital industry, an industry that has had a tremendous impact on the development and growth of entrepreneurial companies. In summary, the formal venture capital industry includes several hundred venture capital firms that raise capital from investors and that use that capital to invest in privately held emerging growth companies; the venture capital industry has grown 10-fold over the last dozen years or so with several individual venture capital firms over $1/2 billion in size; although traditionally venture capitalists invested in early stage "high tech" businesses, there has been a movement towards investments in "low tech," later stage ventures as well as in LBOs; the informal venture capital industry may be larger than the formal venture capital pool and is an especially important source of funding for early stage ventures; and investors, be they formal or informal venture capitalists, tend to make investment decisions based on the definition of the business, marketing capabilities, management capabilities, and the attractiveness of the financial arrangement.

Footnotes

[1]The reader should not be misled by the $200 million figure in management fees for the Warburg, Pincus fund. Firstly, Warburg, Pincus would receive that amount only if the fund were in place for its *full* lifetime of 12 years; this has not occurred for any of its previous funds. In addition, contrary to the practice of many other venture capital firms, Warburg, Pincus does not take any investment banking or other transaction fees from its funds.

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