Early stage investors versus venture capital: The importance of exit timing and price

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The “successful exit” ultimately determines the performance of any investment in early stage ventures. The exit price and timing will be critical to overall investment profitability. Because of the realities and incentives they face, participation by venture capital (VC) firms in later stage rounds may often negatively impact the investment returns of early stage investors.

Investments in Seed or Series A rounds of financing can give investors valuable access to companies at the earliest and riskiest part of the capital structure lifecycle: the beginning. If successful, these discrete, early ownership stakes can provide a return far in excess of those in the public markets. The risk from early stage investing, however, is quite high. The Bureau of Labor Statistics (BLS), for example, estimates that only 20 percent of businesses survive after their first year of operation. The probability of “home runs” for a business is much lower.

While price and timing are the ultimate determinates of investment profitability, there are two measures of investment return: return on investment (ROI) and internal rate of return (IRR). ROI, which is defined as net exit price divided by initial investment, does not take into account the time an investor waits to receive his or her return. IRR, on the other hand, which is the single rate that discounts the sum of all cash flows back to the present value of the initial investment, is very sensitive to time. Typically, early stage investors target ROIs of five to ten times their initial investments within five to seven years to achieve IRRs of over 30 percent. As an example, say an initial investment of $500,000 returned $4 million, the ROI for an investor would be eight times his or her initial investment or a 700 percent return. If that $4 million were returned in five years, then the IRR would be 50 percent. If that $4 million were returned in seven years, the IRR would fall to 35 percent.

Although non-dilutive investments by competent venture capital fund partners can bring value to early stage investments, the structure of portfolios and resulting performance requirements can put VC funds at odds with early stage investors. Typically, VC funds target aggregate portfolio returns of over 20 percent. If the probability of a successful exit is close to the BLS’ estimate of two out 10, this means that, on average, for every 10 VC portfolio investments, eight will fail or perform poorly. The weight of portfolio return will therefore need to be borne by one to two investments. So, if a seven-year portfolio strategy is composed of 10 equal dollar investments and targets an aggregate return of 20 percent, and eight of these investments either fail or underperform, the remaining two investments will need to
generate returns of over 50 percent per annum.

Moreover, as venture capitalists typically enter later, they face a different timeline than those individual investors who commit capital in the very early stages. Venture funds typically have lives of five to 10 years, which means a VC investor that is looking for the “home run” in the context of his or her two out of 10 portfolio realities will be incentivized to hold (and shop for an exit) for as long as possible, ultimately lowering the IRR for the early stage participants.

In conclusion, different incentives and investment horizons may mean that the investment objectives of early stage investors will conflict with those of venture capitalists who enter in later rounds. Early stage investors may find themselves joined to the complex realities of the management of portfolios, which they had never considered at the time of their initial investment. An investment horizon may be significantly lengthened or a target exit price may be raised for reasons beyond the single investment. It is advisable that investors in early stage or startups consider these factors before investing.