qodeoview

A Venture Capital/Private Equity industry market snapshot by
Tai Mai MBA Candidate, Georgetown University, McDonough School of Business

Washington DC
The Amazon Effect

Washington, DC is better known as the seat of the US federal government than as a centre of entrepreneurship. But it also has a vibrant and growing community of venture capital and private equity firms. The region has received a boost from Amazon's decision to open new offices in Arlington, Virginia, which is likely to attract new talent and create a favourable environment for start-ups.

This Qodeo report brings unique insights into the background and activities of firms in the DC area (DC, Maryland and northern Virginia), including venture capital, private equity and angel groups. It also provides some general commentary on the investment and entrepreneurial VC & PE community in the area.

Qodeo spoke to 88 different people from 75 different firms. 40 people responded, 32 interviews were scheduled, and interviews were conducted with 23 firms. Interviews took place between December 2018 and February 2019.

Here we share their unique insight into industry trends and their medium - and long-term outlook.

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StartupHoyas. The Georgetown Entrepreneurship Initiative

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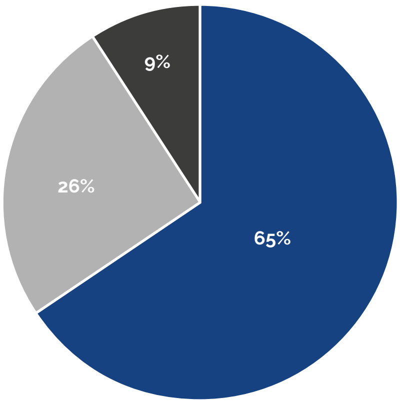
Who did we speak to?

Participants	Median	Min	25th Pctl	75th Pctl	Max	N
Firm Age (Yrs)	11	3	8	20	42	23
Investment Professionals	6	0	3	11	58	23
Recent Fund Size ($ M)	169	25	111	464	3300	18
Average Investment ($ M)	4	0.125	1.375	10	425	23
Portfolio Companies	23	5	14	45	280	23
Management fee	2.0%	1.0%	2.0%	2.0%	5.0%	16
Performance fee	20%	10%	20%	20%	30%	16

For this report the median age of firms interviewed by Qodeo is 11 years. This means that half of the firms were established after the financial crisis in 2008. The table also shows that at least half of the participants follow a 2/20 fee structure.



Participating firms by type

- Venture Capital
- Angel Group
- Private Equity

74%

of firms have at least one investment professional with a background in entrepreneurship or as industry operator

"partners usually operate more effectively by relying on their network than on the deals sourced by their junior analysts"

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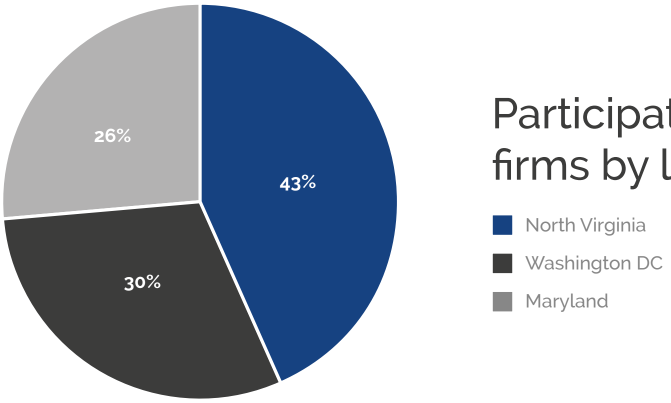
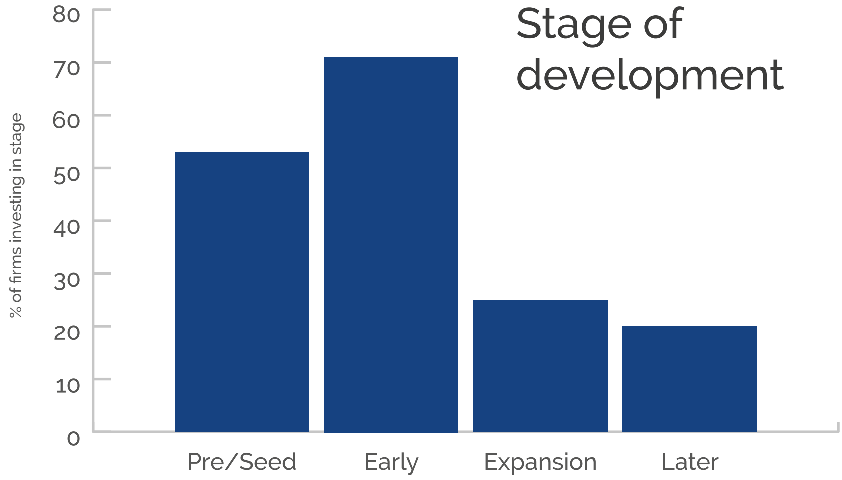
Participating firms by location



Stage of development



Most VC firms and angel groups focus on the seed and early (series A, series B) rounds while PE firms focus on the expansion/growth rounds (series B+) and later stage mature companies.

These stages are often loosely defined. Sometimes, firms can fall under multiple stages of development.

The Software-as-a-Service (SaaS) / Enterprise sector is the highest with

57%

of firms investing in this area

"Most firms in DC play to the strength of the region and focus on sectors with significant local deal flow"

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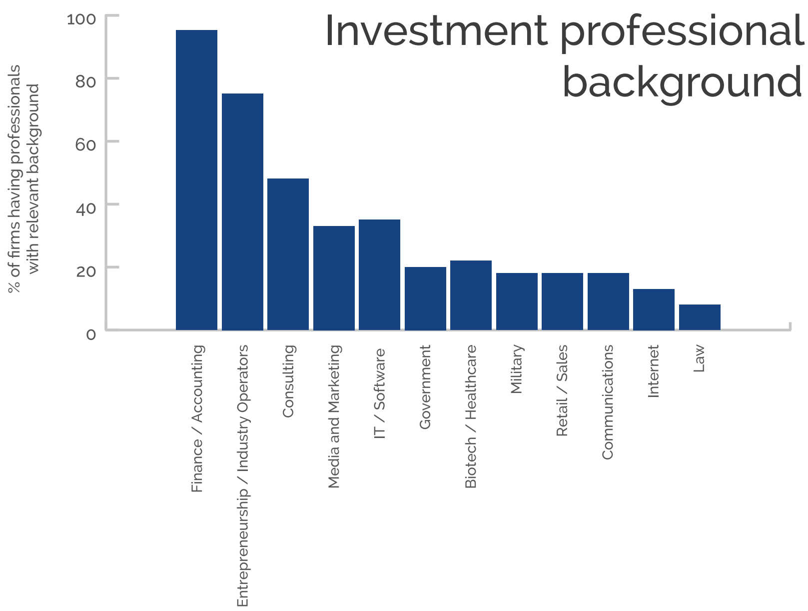

Firms have investment professionals who started their careers in many different roles and industries. Almost every firm has at least one investment professional with a background in either finance or accounting. 74% of firms have at least one investment professional with a background in entrepreneurship or as industry operators.

Three VC firms indicated that they never have or no longer hire junior analysts or associates because they have found little value in hiring these individuals. The criticism is that junior analysts and associates are not as effective at sourcing new deals, and that partners usually operate more effectively by relying on their network than on the deals sourced by their junior analysts and associates.

One firm also expressed that they did not see their past junior associates migrate well into more senior roles where they would be responsible for selecting companies to invest in. This firm noted that none of their past associates performed well at selecting companies that resulted in good investment returns. A couple of firms also expressed that they did not have enough work suitable for more junior roles, such as financial modelling and valuation work typically more common of PE firms, to support hiring them.

To evaluate potential investments about

74%

of firms specifically mentioned looking at the company's potential market while

65%

mentioned the team and financials

"avoid investing in large markets such as the Bay Area"

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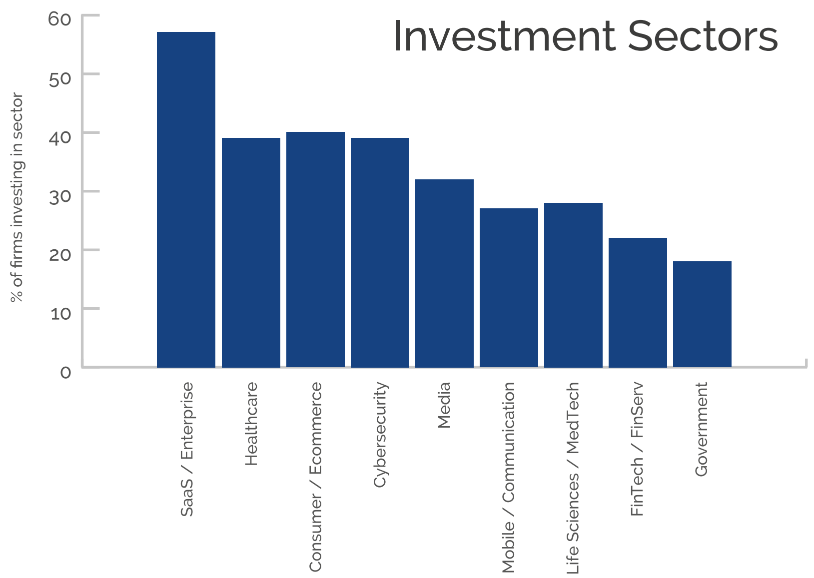
Sector Focus



Most firms in DC play to the strength of the region and focus on sectors with significant local deal flow.

The Software-as-a-Service (SaaS) / Enterprise sector is the highest with 57% of firms investing in this area. The Cybersecurity and Government sectors are popular because of the proximity of government agencies, such as the National Security Agency, Department of Defense, and Central Intelligence Agency, and defence contractors, such as Lockheed Martin, Raytheon, and Boeing.

The Healthcare and Life Sciences/MedTech sections are popular because of healthcare organizations, such as National Institute of Health, Inova Health System, and MedStar Health, and educational institutions, such as the John Hopkins University, University of Maryland, and Georgetown University. Some participating firms that have a DC presence but are not regionally focused largely invest in areas for which they have operational experience.

35%

of firms focus on the DC and Mid-Atlantic area, and about 30% have an international focus

"The Cybersecurity and Government sectors are popular because of the proximity of government agencies"

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A number of firms also indicated that their investment strategy is not sector-focused but rather based on value. They generally invest in companies with a strong founding team, good business models and high growth potential.

Two firms indicated that they invest in sectors that not considered by other firms. Their reasons for targeting these sectors included potentially lower valuations and less competition.

Investment Criteria & Dealflow

Deal funnel	Median	Min	25th Pctl	75th Pctl	Max	N
Recent reviewed/ deals	56	8	29	150	600	17
Recent deals pa	4	1	2	9	24	20

VC firms typically review more than 100 deals for every investment made. PE firms typically review a lower number of potential deals for every investment made. For angel groups, this was harder to quantify as individuals within the group oftentimes evaluated a large number of companies to select the few that would get presented to the full group. The number of deals per year for any given firm was dependent on their fund size and target investment size. Firms that had a low fund size to target investment size ratio had a lower number of deals per year, whereas firms that had a high fund size to target investment size ratio had a larger number of deals per year.

77%

of firms indicated that they prefer at least a board observer role

"VC firms believed the founding team to be the most important criteria in evaluating potential investments"

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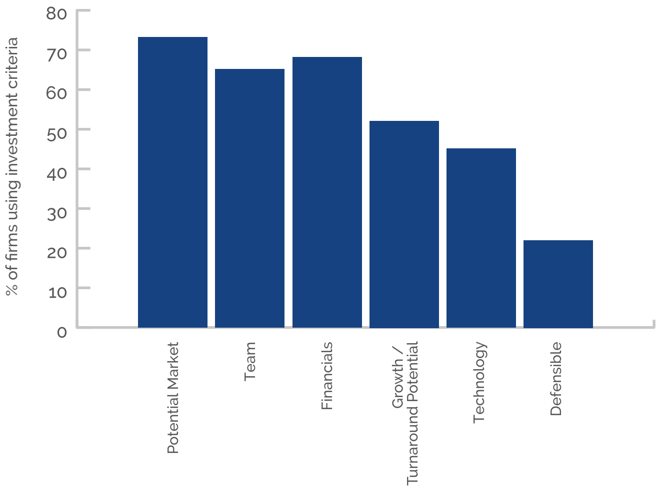

To evaluate potential investments about 74% of firms specifically mentioned looking at the company's potential market while 65% mentioned the team and financials.

VC firms generally expressed that they believed the founding team to be the most important criteria in evaluating potential investments. VC firms indicated that they looked for founders with past successful exits, founders who have hired competent teams with complementary skill sets, and founders who are receptive to feedback and ready to respond.

Some PE firms also indicated that they looked for synergistic opportunities, e.g., opportunities to create synergies from merging multiple investments.

Geography focus

Most firms do not strictly adhere to a restriction on geography. However, most firms expressed a preference toward particular geographic regions based on prior experience or their investment thesis. 35% of firms focus on the DC and Mid-Atlantic area, and about 30% have an international focus. Three firms specifically mentioned that they avoid investing in large markets such as the Bay Area. These firms reasoned that any companies that would reach out to them from those markets would likely be over-valued or of low quality because they would have been passed over by other firms in those markets.

70%

of firms assist with business development and networking to expand their portfolio company's base of customers

"VC firms indicated that they looked for founders with past successful exits"

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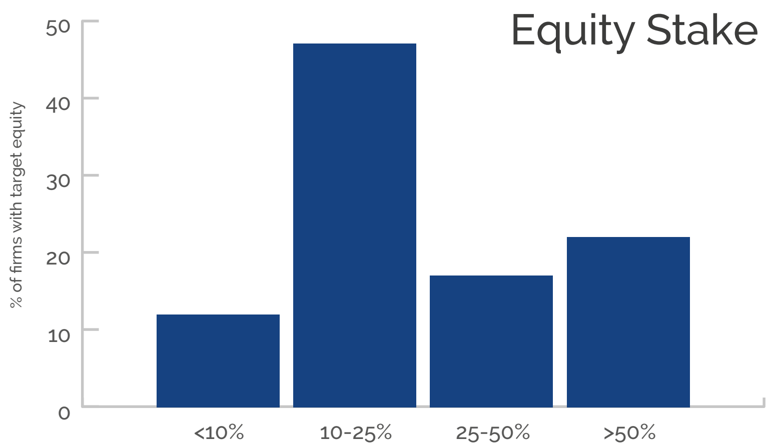
Deal terms

Target equity level: Firms interviewed by Qodeo varied in the amount of equity they preferred to have in their portfolio companies. A large number of firms indicated that they preferred to have meaningful equity ownership, i.e., equity ownership of at least 10%. Firms generally indicated that they wanted meaningful ownership so that they would have influence on the direction of the portfolio company.



Growth firms and angel groups have the lowest target equity levels of less than 10%. VC firms generally have target equity levels ranging from 10-25%. PE firms generally seek outright ownership, but sometimes allow founders to keep a small ownership stake of less than 20%. Two firms expressed that allowing the founders to retain ownership can help provide motivation and align the incentives of founders with that of the firms.

A number of firms with lower target equity levels also expressed that those levels were not hard ones but rather were depending on the cumulation of factors involved in a particular deal, such as the amount of investment the firm is putting in and the company's valuation. Firms with higher target equity levels (i.e., greater than 50%) placed greater emphasis on achieving those levels.

64%

of firms noted that they believed the artificial intelligence, machine learning, and analytics sector to be hot

"allowing the founders to retain ownership can help provide motivation and align the incentives of founders with that of the firms"

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Portfolio Company Valuation: Many firms told Qodeo that the company's valuation was also a factor that they considered when making an investment. Price sensitive firms placed significant focus on the potential return of their investment and therefore were cognizant of potential dilution that may result from down rounds if their invested round was overvalued. While firms investing in early or seed stage companies considered a company's valuation, they indicated that this valuation was oftentimes not based on financial data of the company but data of other comparable companies.

Governance: Most firms also expressed interest in having control or influence in the decisions made by their portfolio companies, specifically through board positions. 77% of firms indicated that they prefer at least a board observer role. Two firms indicated that they actually preferred board observer roles to a board position, to mitigate their risk in being involved in the company's operations. Some firms also expressed that they did not prefer a board position because they felt that the position is not worth the amount of work required of it.

Lead and Syndication Preference: Firms varied in their syndication and lead preferences. Angel groups and VC firms generally syndicate because their fund size does not allow for full investment in rounds. In contrast, PE firms generally do not syndicate because they ultimately want to have a full or majority stake in the company. With syndicated deals, 64% of firms indicated that they preferred to lead the round so that they could dictate the terms and influence which other firms to join the round. Firms tend to also be very particular in who they syndicate with because of past experience with and opinion of other firms.

Other Deal Terms: Other deal terms discussed included liquidation preferences, participation, dividends, warrants, and anti-dilution. Firms mostly downplayed the importance of these deal terms and say that market terms such as 1x liquidation preference with no dividends or warrants are the norm. Firms say that many of these terms tend to overcomplicate deals and can have a negative effect on the relationship with or motivation of the company.

"PE firms target lower IRR than VC firms, depending on how risky their assets are and how much leverage the firm uses"

"VC firms tend to have a lower ratio of exits to investments than PE firms"

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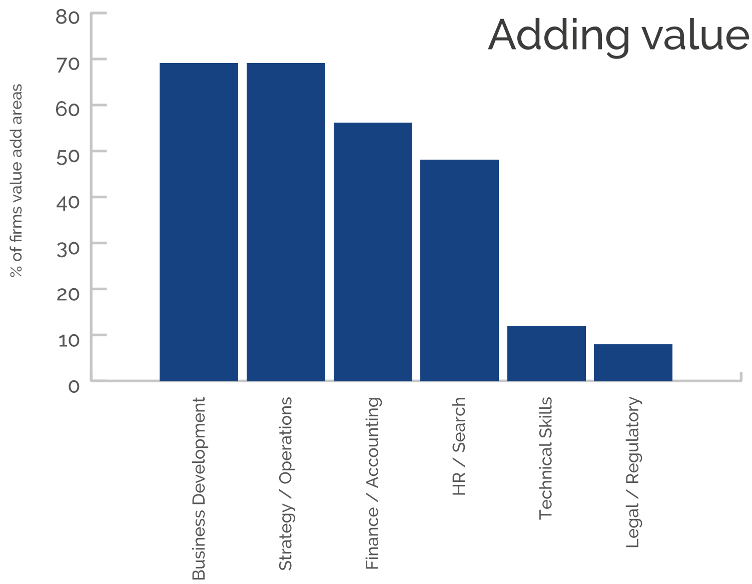
Post-investment strategy

A majority of firms told Qodeo that they are actively involved in driving the direction of the portfolio company post investment. Many firms invested in companies in sectors where they had previous experience with. Therefore, most firms stated that they would use their experience as well as network within the relevant industry sector to help the business of their portfolio company.

While VC and PE firms generally were actively involved with their portfolio companies, angel groups were more passively involved. With angel groups, some investors in the group will take an active involvement while most remain passive.

70% of firms assist with business development and networking to expand their portfolio company's base of customers. This is closely followed by strategy / operations, where firms would provide advice on the strategy direction of the company and help drive strategy and operations. Other areas that a large number of firms assisted with included financing / accounting (e.g., corporate development, seeking additional investment, financial accounting) and HR / search (e.g., recruiting, employee management).



"meaningful ownership so that they would have influence on the direction of the portfolio company"

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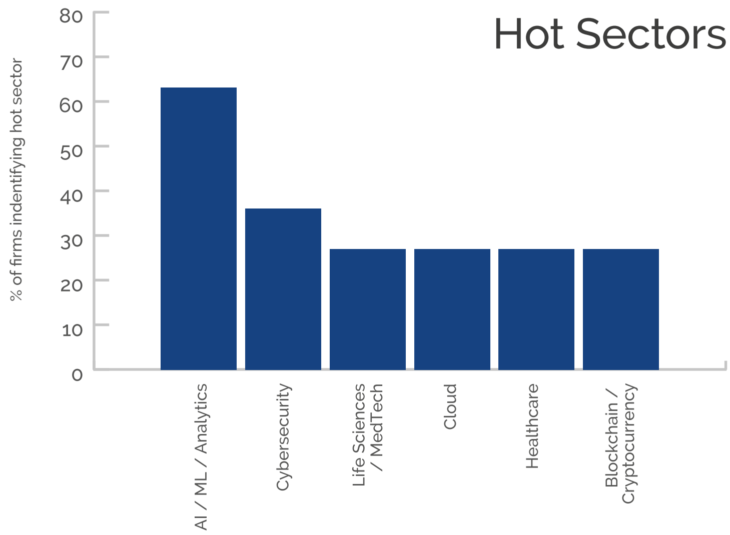
Overall, VC firms tend to focus on bringing a product to market, advising on the strategic direction of the company, building a new team, and raising additional capital. PE firms focus on providing companies with access to more customers, acquiring and merging businesses, divesting business units, and replacing management teams with new ones.

Market overview

Hot sectors

Firms had some variability in the sectors that they believed are hot, i.e., have a high level of deals. Most firms listed around a handful of hot sectors, while a few firms identified longer lists of hot sectors.

64% of firms noted that they believed the artificial intelligence, machine learning, and analytics sector to be hot. One VC firm expressed that there could be a limit to the capabilities of this technology in certain applications (i.e., applications where humans may have an advantage), and therefore questioned the large amount of investment that have been made in certain companies in the sector aiming to replace humans.



"questioned the large amount of investment that have been made in certain companies in the sector aiming to replace humans"

"sectors that appear to be closely tied to one another not being hot at the same time"

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Specific insights on sectors included:

- Impending legislation and regulation, geopolitical developments, and government spending having an impact on deals in a market, such as DC, where many of the hot private sectors are tied to the public sector.
- Certain sectors that appear to be closely tied to one another not being hot at the same time. For example, one firm noted that the biotech and medical device sectors were hot at different times, even though many outside of those sectors may have believed the two sectors to move together.
- Some sectors being more active in different markets. Specifically, one firm noted that the media sector is not very active in the U.S. market but is more active in emerging markets.
- Sectors sometimes falling out of favor due to unproven returns in those sectors. For example, a couple of firms noted that they no longer viewed the blockchain / cryptocurrency sector as being hot given that there have not be significant returns in that sector.

Returns

Returns for firms are based on internal rate of return (IRR), which is a typical metric used by VC and PE firms to measure the success of an investment. For many firms, this information was unavailable or difficult to quantify given the age of the firm. Some firms also did not wish to share this information. Qodeo has collected additional information from public sites.

	Median	Min	25th Pctl	75th Pctl	Max	N
Target IRR	33%	8%	21%	35%	35%	8
Exits or Liquidity Events	9	1	3	31	570	19
Actual IRR	33%	17%	28%	37%	40%	6

"Firms generally noted that the market is currently frothy, with high valuations for companies"

"they may still be looking at the same number of deals, they are now reducing their number of investments"

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VC firms target an IRR of 35%. The rationale for this stems from the riskier nature of the asset class, which largely consists of companies that are very early in their development stage. PE firms target lower IRR than VC firms, depending on how risky their assets are and how much leverage the firm uses. Specifically, PE firms using higher leverage and investing in less mature companies generally have higher IRR targets.

On exits, VC firms tend to have a lower ratio of exits to investments than PE firms. Stated differently, VC firms usually have a larger number of investments than PE firms, but both typically have a comparable number of exits. PE firms for the most part usually exit on most if not all of their investments.

"PE firms target lower IRR than VC firms, depending on how risky their assets are and how much leverage the firm uses"

"VC firms tend to have a lower ratio of exits to investments than PE firms"

Exit Timing

Firms noted that exit timing has increased over the years but has now stabilized. Generally, firms express that exit timing is now greater than 5 years. A couple of firms noted that the number of exits has not changed but that more exits are now via acquisitions instead of an initial public offering.

Most firms have an expressed timeline for their fund, typically around 10 years. A couple of firms noted that they do not have any specific timing in mind for their exits or their fund.

Three firms also indicated that they have started to invest in earlier stage companies due to the higher valuation of the market. One firm expressed that this was due to the limitation of their fund size. Other firms noted that the over-valuation of a company compounds itself in later investment rounds and therefore making an investment during an earlier round can help avoid this.

On types of exits, firms noted that most companies are currently exiting via acquisitions but that they expect this to shift toward initial public offerings in the near future.

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DC Metro area & the Amazon Effect

Firms had mixed thoughts on the DC market, but most agreed that the quantity of deals and entrepreneurs is lower in DC than in other large cities. Some firms also expressed that they felt the quality of companies and talent in DC was low compared to the Bay Area, Boston, and New York.

They also noted that most of DC's entrepreneurship talent pool comes from government (e.g., those exiting the government) and local universities (University of Maryland, John Hopkins, George Washington University). Firms generally noted there are very few serial entrepreneurs in DC, except notably AOL founder Steve Case, who founded Revolution (a VA based VC).

Many firms were optimistic about the prospects of Amazon's new headquarters in DC, noting that they expected this to bring more technology talent into the DC market and keep more young talent in DC. In the short term, most firms predict that Amazon may take some talent away from the start-up industry but that in the long term, there should be a greater pool of talent as folks from Amazon being their own start-up efforts. Overall, while firms expect that Amazon's presence will drive up the cost of talent in DC, most firms felt that start-ups will be able to compete on costs. Two firms expressed the opposite view, believing that even in the long run, Amazon will take talent away from the start-up industry.

> "optimistic about the prospects of Amazon's new headquarters in DC"

> "short term, most firms predict that Amazon may take some talent away from the start-up industry"

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Market Outlook

Firms generally noted that the market is currently frothy, with high valuations for companies. This has led many to proceed with caution and reduce their number of investments. In particular, firms have expressed that, while they may still be looking at the same number of deals, they are now reducing their number of investments by two to three times. In one extreme case, one firm noted that it reviewed more than 600 companies and ultimately only made one investment.

A couple of firms also noted that some companies now may announce that they are interested in exiting but ultimately not move forward with an exit. For example, a couple of PE firms have encountered companies that would undergo a roadshow but not agree to any selling because they did not get their desired valuation. This activity has further driven up the valuation of companies.

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qodeoview market snapshots are reports written by qodeo-MBA researchers from 30 leading Business School alliance members about key venture/private equity and entrepreneurial trends and markets. These cover EMEA, North America & Asia. Insights gleaned are used by qodeo's investor:entrepreneur matching service and to assist corporate advisors build related pipelines. Register at www.qodeo.com to receive these as part of our service.

Matching investors with entrepreneurs

Qodeo monitors the venture ecosystem, identifies the best opportunities automatically, and brings entrepreneurs, investors and corporate advisors together to make it work. This is a brand new service for a new generation of entrepreneurs and investors who expect to be able to behave differently, and to do business differently.

List of firms and organisations interviewed:

Accolade Partners
Acon Investments
Arlington Capital Partners
Blu Venture Investors
Blue Delta Capital Partners
Cooley LLC
Core Capital Partners
Franklin Park
Georgetown Entrepreneurship
Georgetown Investment Office
InSITE Fellowship
K Street Capital
Lavrock Ventures
Maryland Venture Fund
Middleland Capital
NAV.VC
National Venture Capital Association
NaviMed Capital
New Dominion Angels
North Base Media
QED Investors
Revolution Ventures
Route 66 Ventures
Sachs Capital
Sands Capital Ventures
SineWave Ventures
Updata Partners
(two firms did not wish to disclose their participation).

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