EMERGING BEST PRACTICES FOR BUILDING THE NEXT GENERATION OF VENTURE-BACKED LEADERSHIP

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NVCA
National Venture Capital Association

During the past decade, the venture capital landscape has changed dramatically. Today, the path to liquidity is uncertain and considerably longer, raising a venture capital fund is a growing challenge, and the evolutionary churn of emerging sectors is changing what kinds of companies are attracting venture capital. Innovative companies in a wide range of sectors are also more vulnerable to shifting government regulations and policies, be they related to national broadband policy, the FDA approval process or government subsidy of emerging clean technologies.

To learn more about the implications of this transformed environment on the characteristics, skill set and experience required of VC-backed CEOs, Spencer Stuart and the National Venture Capital Association (NVCA) launched a study in March 2010. It consisted of in-depth interviews with VC firm leaders across a variety of sectors, along with a quantitative survey completed by more than 200 NVCA members. This year's study follows up on a similar study conducted in 2001.

While certain characteristics or attitudes of venture capital investors have remained stable over time, there are some interesting new trends as the industry adapts to the changing environment. What emerged from the data were clear opportunities for venture capital firms to take a more structured approach to building strong, independent and diverse boards of directors for their companies, and to approach management assessment of their portfolio companies in a more rigorous, ongoing fashion in response to the longer average tenure of their management teams.

People Remain Paramount

Venture capitalists consistently believe that the "people" factor is paramount. In both 2001 and 2010, strength of the management team was considered the most important factor, followed by market sector, when deciding whether to fund a venture. Proprietary product or service and business model both trailed slightly behind market sector.

"When we make an investment where there's something exciting about the market or business model and we say, 'management may not be perfect, but the opportunity is so great, we can fix it later,' it usually turns out to be a mistake," said Deepak Kamra, general partner at Canaan Partners.

Venture capitalists often prioritize management before the product, service or business model because the challenges associated with scaling a business in a rapidly changing business environment are vast. "Only the best management teams can simultaneously scale a business and respond to an ever-changing business landscape," said Mark Heesen, president of the National Venture Capital Association. "Technology and circumstance are constantly changing — rarely does the end result look similar to the original business plan."

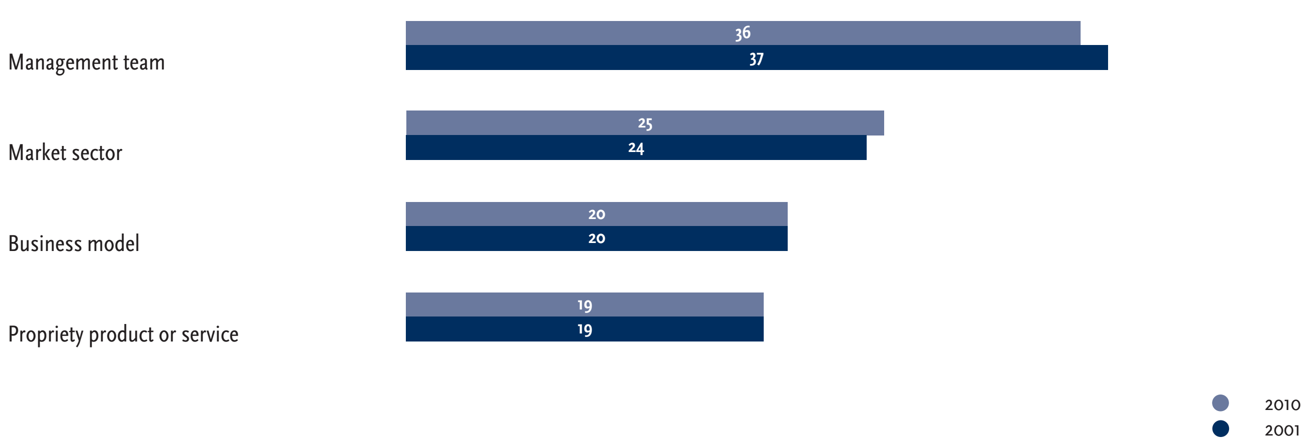
That said, some venture capitalists believe that backing the right horse — not just the right jockey — is increasingly critical in an environment where the path to liquidity is longer and more fraught with roadblocks than ever. "Management is critical to success, but you can always change out the management team to bring in somebody who can be more effective," said John A. Deedrick, managing director of Accuitive Medical Ventures. "You can't always change out your market of interest, intellectual property, clinical data and ownership of the asset."

Traits That Make a Successful VC-backed CEO

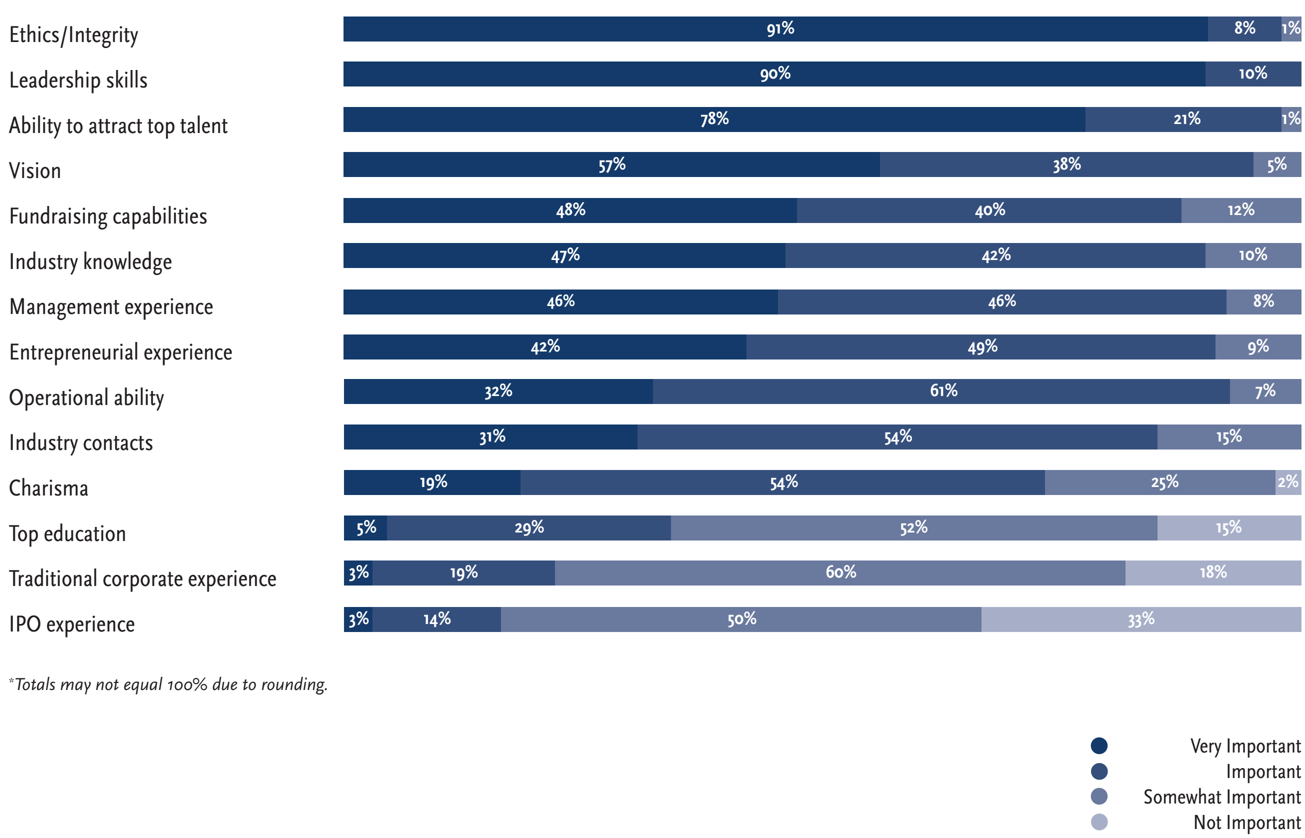
The traits most commonly identified as "very important" for VC-backed CEOs are traits that are universally acknowledged as desirable qualities for any leader: ethics/integrity, leadership skills and the ability to attract top talent. However, vision and fundraising skills are more important than they were a decade ago. Vision, for instance, was fourth-most-commonly ranked "very important" in 2010, but only ranked seventh in 2001. Fundraising, which ranked fifth in 2010, ranked only eighth in 2001.

"In 2001, it was easier to raise money, and you didn't need your business model to be perfect to get a decent exit," said Kamra. "If you had a good story, you could sell your company for a lot of money without actually having to perform. Back then, many visions could be potentially profitable. Now, you have to find the right one."

The most important factors in your decision to fund a venture (total = 100)



Most important characteristics for VC-backed CEO candidates in 2010*



Totals may not equal 100% due to rounding.

There is no question that it is more challenging for these companies to raise venture capital than it was a decade ago. According to a recent PricewaterhouseCoopers/NVCA Money Tree™ Report using Thomson Reuters data, the amount invested in VC-backed companies in 2001 exceeded $7 billion, more than double the roughly $3.3 billion invested in 2009. In some cases, this environment has made firms less likely to embrace leaders whose primary strength is salesmanship in favor of executives who not only have a proven track record for raising private capital, but also understand the value of capital efficiency.

"I think people have lost some of their enthusiasm for CEOs whose main strengths are sounding good and being able to take a company public," said James E. Thomas, co-founder of Thomas, McNerney & Partners. "People are gravitating toward more substantial business people."

According to the leading capitalists we interviewed, VC-backed CEOs also need a broader, more refined skill set overall today. "I think the number of tools you need to be a successful CEO has probably expanded," said Stephen Bloch, general partner at Canaan Partners. "You really have to be conversant all the way from science to commercialization to be able to put a whole story together. It's very demanding. The really top CEOs can either play in all those areas, or know how to find the right people to fill in the gaps where they can't do it or understand it themselves."

Somewhat surprisingly, many venture capitalists don't value international experience more than they did a decade ago. Just 19 percent of 2010 survey respondents agreed and 47 percent somewhat agreed that global or international experience has become more important over the past 10 years. While venture capital firms are increasingly funding portfolio companies in international markets, the primary mission for most early-stage investments today is still developing their product or service.

Easier Today to Attract and Retain CEO Talent

According to our 2010 survey results, companies are finding it slightly easier today to attract and retain leaders for their portfolio companies. "It is easier to attract and retain top CEO talent for two reasons," said Kate Mitchell, NVCA chair and co-founder and managing director of Scale Venture Partners. "First, CEOs are walking away from less upside by leaving their current position than they were a decade ago. Second, with less capital in the venture industry, each startup has a higher chance of being a success — we are no longer financing too many 'me-too' companies."

Despite these facts, finding quality leaders is still no easy task, in part because of the long-term commitment required of today's venture-backed CEOs. "There are many more experienced people around today, but it was in some ways easier to attract a good CEO in the past because of the kinds of exits people were getting and the speed with which they were getting them," said Kamra. "Now, we look for patience and the ability to stick it out — you just don't see the guys who want to score an exit in two years and then return to their winery anymore."

In some sectors, such as the biotech and medical device sectors, increased regulatory hurdles have significantly increased the degree of difficulty for VC-backed CEOs to reach an exit, a factor making it harder to attract talent. But this fact has been counterbalanced by the struggles of big pharma, which are making a greater pool of talent available. "It's harder to get people to be a CEO, but I've always been reticent to take somebody directly out of a big company into a little company anyway," said Thomas. "We're more risky, but as the big companies lay off boatloads of people, so is their alternative."

Meanwhile, growing VC sectors such as clean tech are attracting top talent like never before. "A decade ago, clean tech captured less than 1 percent of venture capital investments, and the key CEOs and executives were often great scientists with no executive experience," said Ira Ehrenpreis, general partner for Technology Partners. "Today, clean tech represents the major global opportunity of our time and, as a result, our sector has become a magnet for the best and brightest."

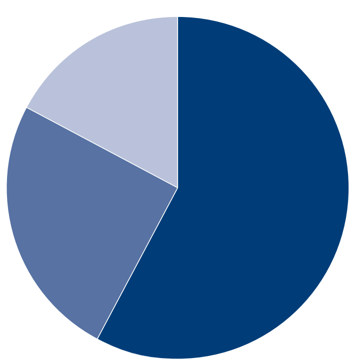
Finding the Next CEO

When seeking talent for emerging sectors with a limited CEO pool, respondents clearly favor proven venture-backed CEOs from unrelated sectors over sector entrepreneurs with no CEO experience or industry leaders from large companies who lack experience in an entrepreneurial environment.

"Because of the lack of history in the clean tech sector, today we often have to partner people who have domain expertise with those who have entrepreneurial experience

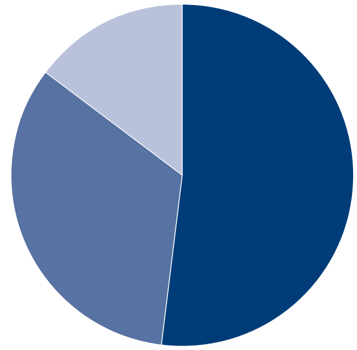
How hard is it to attract and retain top CEO talent to your portfolio companies today compared to 2001?

Equally as difficult	58%
Less difficult	25%
More difficult	17%



Preferred leadership profile for emerging sectors lacking an established CEO candidate pool

Experienced and proven venture-backed CEOs with experience in unrelated sectors	53%
Promising entrepreneurs with strong sector and technical knowledge but no prior CEO experience	34%
CEO candidates from large companies who have sector knowledge but no prior experience managing in an entrepreneurial environment	13%



— often people who have been successful in IT and life sciences who now want to join clean tech companies," said Ehrenpreis. "Over the next decade, I suspect that we will be able to recruit serial entrepreneurs who also have clean tech domain expertise."

In some sectors, this evolution has already occurred. "There's not this magical group of people who are all of a sudden coming fresh to our industry with this well-rounded business sense," said Thomas, who focuses on healthcare companies. "We've just grown a pool of guys who are now on their fourth company through the churn of what we do."

While venture capitalists seem willing to consider talented leaders from different sectors, they are less willing to do so in sectors such as biotech, where a lack of understanding of regulatory issues can be a considerable hurdle to overcome. "I find that people from outside this business don't understand the regulations," said Brenda Gavin, partner at Quaker BioVentures. "They have an attitude that, 'if you make a cure for cancer, of course the FDA will approve it.' And that's absolutely false — you still have to go through these incredible hoops to get there. I would say that the person absolutely has to come from the pharma or medical device world originally."

Even more foreign than changing sectors, however, can be the transition from having only large company experience to becoming a venture-backed CEO — and VCs increasingly prefer to find executives who already have a small-company education. "I look for leaders who have met challenges in a small company, and what they did and how they reacted in response," said Anand Mehra, partner at Sofinnova Ventures. "You have to push through a lot in this environment that can be unpleasant. If someone's been sheltered at a big organization and hasn't had to deal with some of the difficulties and uncertainties you face in a small company, it's hard to predict how they're going to react."

Assessing the Management Team

Despite the fact that many venture capitalists consider top management the single most important factor in the success or failure of a portfolio company, assessing leadership before and after the hire remains an imperfect science. "Finding the right CEO and judging people in general is the toughest part of our job," said Kamra.

Despite the sea change in the venture capital landscape over the past decade, firms haven't significantly changed their approach to evaluating senior-level talent. Nearly all survey respondents said they always review key management's resumes and experiences. Most also conduct personal interviews with key executives, check provided and independent references, look at their interactions with the team and follow their gut. Today, however, venture capitalists are more likely to conduct a background check before the hire: 44 percent of 2010 survey respondents said they conduct formal background checks significantly or somewhat more often than they did 10 years ago.

As the VC industry matures, investors feel more confident in their assessment practices. In 2001, only 4 in 10 venture professionals predominantly agreed that their firms recruit the best talent, consistently and thoroughly assess management teams or remove low performers quickly. In 2010, 84 percent agreed that their firms recruit the best talent, 63 percent agreed that they consistently and thoroughly assess management teams, and 67 percent agreed that they remove low-performing CEOs from portfolio companies quickly.

Firms remain less systematic, however, about conducting formal assessments of their CEOs and top managers after the hire. Only 25 percent of respondents to our 2010 survey conduct formal, ongoing management assessments after the investment has been made.

In part, this may be because enthusiasm for formal processes is not consistent with the DNA of the venture capitalist. But the biggest factor is that VC firms feel that they are already linking the CEO's goals and accomplishments with the needs of the company through their compensation structure.

"We always set individual goals and corporate goals," said Bloch. "For the CEO, those goals tend to merge and are less tactically operated than they are related to the general strategy for how we are trying to increase the value of the company. Going one level down, the CFO or chief of sales would have goals that are a little more commensurate with a specific set of tasks."

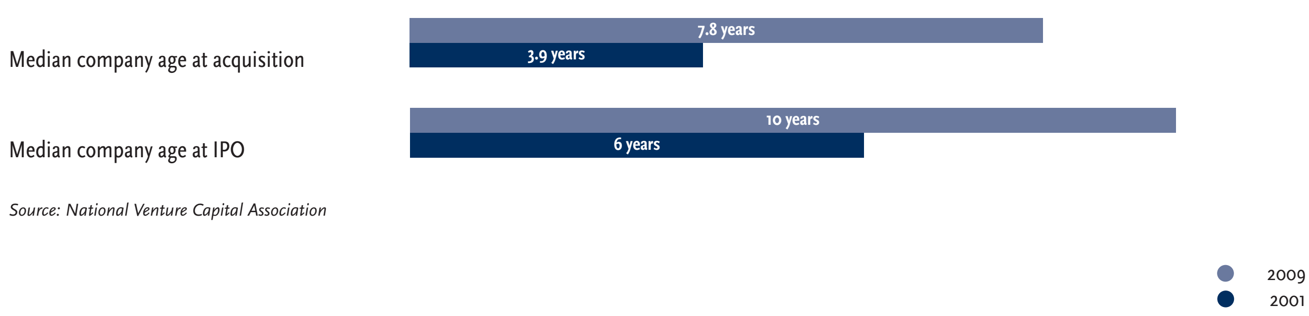
In many firms, however, a greater attention to ongoing assessment after the hire could represent the greatest potential area of improvement for talent management in the industry. "In the past, most VCs would tell you that there are CEOs who were experts at creating companies and getting from point A to point B, middle-stage managers and late-stage leaders," said Heesen. "CEOs knew going in that it wasn't a long-term job. Today's longer runways calls that whole traditional way of doing things into question, and these reviews become more important because people are around longer than they were in the past."

The Compensation Question

VC-backed CEOs are being paid more than they were 10 years ago, with 47 percent of respondents saying that they are paying CEOs both greater cash compensation and greater equity. "Compensation has definitely changed," said Gavin. "CEOs used to be willing to take a hit on compensation or some of the benefits they'd get from big companies with the expectation that they're betting on the equity. Today, with the high risk we see with our companies and the lack of public markets, we have to pay more, in the biotech space especially."

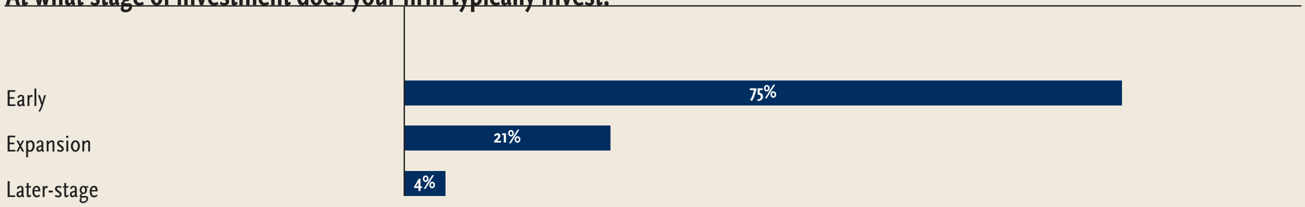
In addition, venture capitalists note that employment contracts including negotiated severance packages have also become more common for CEOs and other senior

A longer path to liquidity

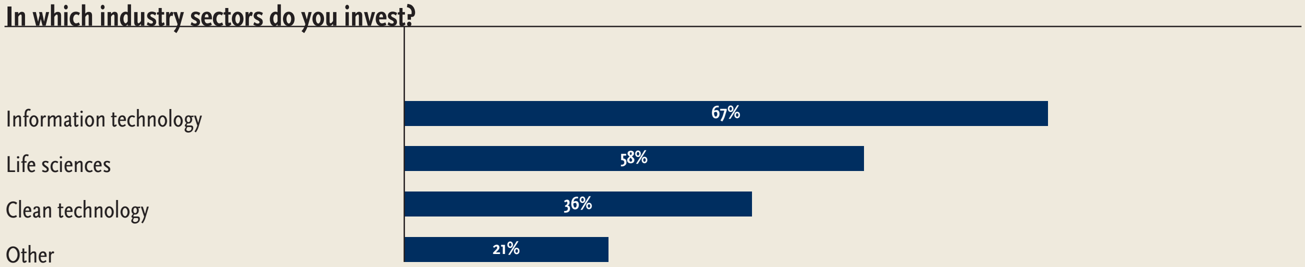


Source: National Venture Capital Association

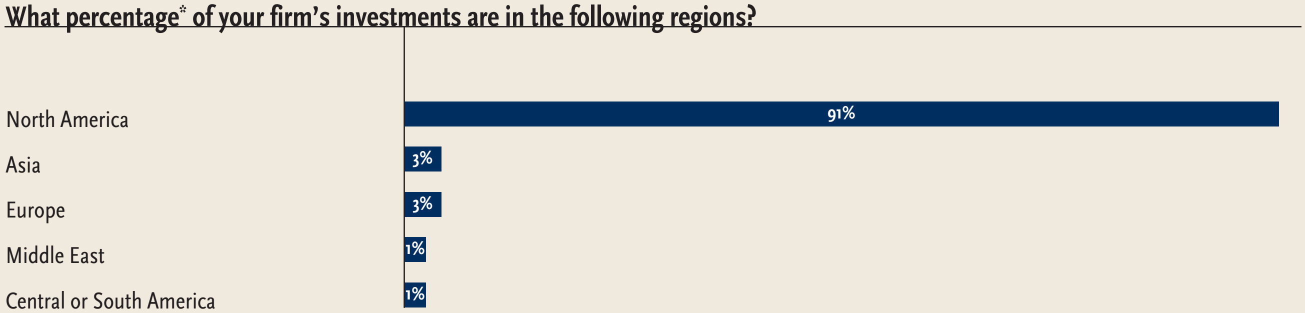
At what stage of investment does your firm typically invest?



In which industry sectors do you invest?

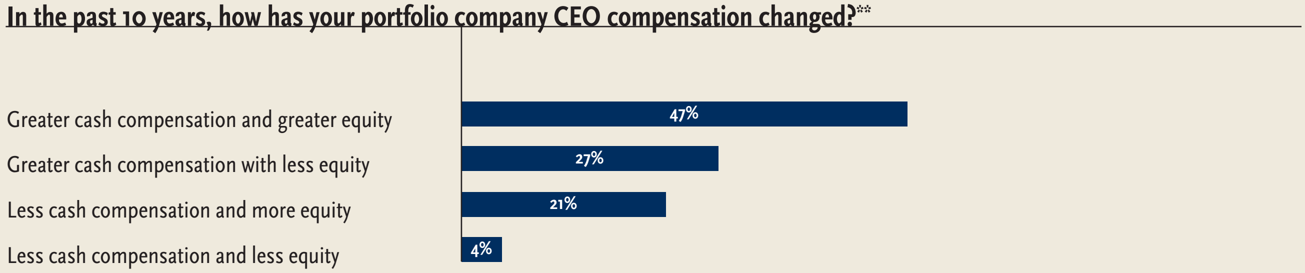


What percentage* of your firm's investments are in the following regions?



Totals do not equal 100% due to rounding.

In the past 10 years, how has your portfolio company CEO compensation changed?**



**Totals do not equal 100% due to rounding.*

With the longer path to liquidity, are your portfolio companies recruiting more independent/outside board members?

managers than they were a decade ago. Overall, however, changes in compensation have been gradual.

"I'd say that salaries have probably crept up 5 percent a year for the last five or seven years, but if you measure where a private venture-backed company is compared to public companies, it's probably in the 25th to 50th percentile at most on the cash," said Bloch. "On the equity, it's substantially more — so people are really playing for that upside."

On the whole, venture capitalists strongly favor compensation structures that are designed to drive performance. "Having a CEO who says, 'I'm going to get this done in this time frame on $10 million,' and having their compensation tightly linked to that aligns interests and makes all the difference," said Mehra.

As a result, venture capitalists continue to show a strong preference for compensation packages that link CEO pay to company performance with an emphasis on stock options and other noncompensatory incentives. "You want to keep the entrepreneur and top management hungry," said Heesen. "You don't want to starve them, but you want to keep them constantly looking to eventually cash out at a handsome rate through a good acquisition or an IPO. Giving them incentives before that may destroy your long-term goals."

Board Trends

At the board level, executives are also commanding greater compensation — and being asked for a greater commitment in return. "Liability issues have increased and the time involved has become much larger today than it was in the past," said Heesen. "It isn't just about going to a quarterly board meeting anymore. You have to thoroughly understand the financial arrangements of these companies and very often also be steeped in the technology of these companies to really be a capable board director. It's a limited class of folks you can go after at the end of the day, and that increases the compensation for them."

In particular, directors of venture-backed company boards are showing less willingness to work for only equity compensation. "One thing I've seen is that more and more board directors in private companies want to be compensated in cash, because it's time-consuming and the liquidity paths have been lengthy," said Bloch.

Even when they are receiving equity compensation only as pay, board members are increasingly expected to be valuable contributors to the organization. "If you're giving someone a quarter or half of a percent of the ownership of the company, they'd better add value," said Deedrick. "I don't want them to come six times a year and pontificate — I need them to dig in and help."

In addition to expecting more of their board directors, venture capitalists are also recruiting more independent board members. Seventy-five percent of 2010 survey respondents said they are recruiting more independent/outside board members now that they face a longer path to liquidity.

"The board governance and guidance principles that apply to young IPO companies also apply equally to late-stage private companies," said Mitchell. "Since IPOs are happening at much later stages in a company's life than a decade ago, more private boards look like public boards did a decade ago. This makes sense, since many of these firms have revenues over $100 million and are facing the same challenges as their public peers."

Ninety-three percent of 2010 survey respondents said that one reason for the increase in board members is to provide the company with advisers who have a wider spectrum of experiences and contacts. Fifty-one percent said that another reason is to add directors who have experience with companies that are more mature.

In sectors without an established base of CEO talent, the board also provides an opportunity to bolster the management team with much-needed sector knowledge. "In the IT and life sciences industries, today's leading companies were, at one point, all startups," said Ehrenpreis. "In clean tech, we don't have that luxury, so we recruit board members from the energy industry to bring another perspective from a domain expert."

In fact, the venture capitalists we spoke with agreed that there is a perception that a company that wishes to be regarded as professional and well-managed needs outside board members, and that a company even thinking about an IPO needs two or three independents on the board.

But not all the VCs we spoke with felt that their independent board members have always added as much value as they had hoped. To ensure that their independents bring real expertise, instead of being just figureheads or names for a public offering, firms are increasingly taking a more strategic approach.

"Today, there's less cronyism and more real, effective independent board members who are brought on for specific reasons," said Deedrick. "For instance, we just hired two new board members and insisted in a financing agreement last year that one would be an expert in the reimbursement side and one would be an expert on the operational side."

Planning for a Shifting Landscape

As the industry enters a new decade, it's also re-evaluating its strategies. Among emerging sectors, clean technology is the most visible, with 36 percent of 2010 survey respondents saying their firms invest in that area. But investments in the industry's traditional sectors also remain strong: 56 percent of respondents invest in the life sciences and 67 percent invest in information technology.

As venture capitalists explore new sectors and keep a close eye on shifting government regulations that could affect the economic viability of certain potential investments, they are also seeing a geographic shift in venture capital investment. "Over the last decade, we have seen a growth in the number of successful startups in states like Wisconsin, Florida, Utah and Indiana," said Mitchell. "Now that there are more leaders in these geographies who know how to manage a high-growth company, we will continue to see an increase in venture-backed companies outside the traditional venture centers."

This convergence of new geographies and sectors, more government regulation and longer timeframes to liquidity presents venture capitalists with a challenge — but also an opportunity. As VCs strive to enhance their track record of building great game-changing companies, their efforts may increasingly revolve around the more formal development of boards of directors that resemble those of public companies. Similarly, the frequently longer tenures of management teams and CEOs argue for enhanced assessment and re-evaluation of management teams in the role, instead of just prior to their recruitment. Through these actions, venture capital firms can become more scientific — and increasingly successful — in selecting and managing the innovative, entrepreneurial leaders with the necessary skills to profitably guide the industry into the future.

Spencer Stuart consultants Ben Holzemer, Mimi Hancock, Brigitte Frankel and Jonathan Visbal contributed to this article.

About the Study Partners

National Venture Capital Association

The National Venture Capital Association (NVCA), comprising more than 440 member firms, is the premier trade association that represents the U.S. venture capital industry. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy, and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provides reliable industry data, sponsors professional development, and facilitates interaction among its members. More information can be found at www.nvca.org.

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Our Private Equity Practice supports venture capital and private equity firms and their portfolio companies in their quest for partners and principals, CEOs, CFOs and board directors, as well as officers in marketing, supply chain, sales and other functions. Over the past 10 years, we have completed more than 2,000 assignments for private equity clients ranging from megafunds to startups. Spencer Stuart consultants also provide clients a range of specialized advisory services that include board services, pre-acquisition human capital due diligence, post-merger integration, executive benchmarking, management assessment and succession planning.

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