The Real VC Business Model

The previous chapters have outlined how VCs invest too little (for reasons that do not stack up), and then drive companies to a series of adverse decisions and business outcomes while failing to support the management they have emasculated with contractual arrangements. They appoint the wrong people, chose the wrong business strategies and block the companies’ attempts to do anything about it. It is of course a one-sided story: there are many factors contributing to Europe’s lacklustre biotechnology story, and many factors contributing to the few stars in the continent’s dim sky. But the sections above show that VCs both control the companies and act so as to reduce their chances of success, through underinvestment and poor management. Their influence is so all pervading and their role in the industry so crucial that they must be a significant factor in its failure, and we have identified some of the mechanisms through which this occurs.

But this begs a critical question. VCs are not motivated by malice or political aims or (as is the case of many company founders, alas) the desire to see some beautiful science pursued at any cost. They are in it for the money. It is in their interest not to do things that will lose them money, and not to do things (if they have this option) that prevent them from gaining them money. Surely the logical flaw in blaming VC for the failings of the industry, no matter how the data appears to link them to industry failure, is that they have no motivation to fail.

This chapter examines this argument, and finds it wanting. Due to the baroque nature of what is called VC in Europe, VCs have no particular motivation to make their companies succeed, and in some cases positive motivation to make them fail.

The concept of VC is a US invention, and dates to the 1960s. By the time biotechnology came along in the 1970s VC was a well-established business
in the US and Canada, although, as we have seen, it followed rather than lead the charge into the new industry. However, the explosion in VC in the US dates from the early 1980s, coincident with the biotechnology era, and just to be absolutely clear about this, the US biotechnology industry would not have grown at anything like the rate it has without VC. As we have discussed, European VC appeared at about the same time, although risk investment in technology companies had existed in Europe for some time before, just not trading under a ‘VC’ marque.

There have been many studies of how VC works, almost all analysing the US industry. It is useful to summarise the consensus view here, and then see what actually happens in the European biotechnology arena. See [71] for a more detailed description of the general US VC industry.

Typically, a VC fund is a limited partnership, a separate legal entity with two types of partner: General Partners (the management group acting to make investments, monitor them and sell them at the appropriate time) and Limited Partners (outside investors providing the money for investment). In the US there are tax advantages to this structure, and the same structure has generally been adapted to Europe. In the UK funds are often formally based in offshore corporations, again for tax reasons. In Germany institutional investors such as pension funds are not allowed to invest in such offshore vehicles (to prevent investment vehicles avoiding tax and regulatory requirements which the German government wants its pension funds to adhere to), so many non-German VC funds have onshore companies ‘mirroring’ them in which German institutional investors can invest.

The money for investment comes from outside investors. Usually the General Partner will put in a small amount of their own cash (e.g. 1% of the fund): the rest is from the LPs. Most funds (three-quarters according to Sahlman [71]) have a fixed life – all the assets must be realised and the money returned to the partners within the life of the fund. Partners usually do not put all their cash into the fund at once – funds are ‘called down’ as and when the fund needs them to invest, so the LPs have the use of the money until it is needed for investment. However, payment back to the Limited Partners usually only occurs at the end of the fund’s life.

As the capital for investment comes almost entirely from the Limited Partners, the General Partner must have some operating capital to run the investment process, and some motivation to invest effectively. The former comes from a management fee, paid continuously throughout the life of the fund starting as soon as the fund is created (‘raised’), the latter from a profit share, usually called a ‘Carried Interest’. The Carried