3 Takeaways Podcast Transcript
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Ep 61: An Insider's Perspective on Venture Capital: Founder of Sierra Ventures Peter Wendell

INTRO male voice: Welcome to the 3 Takeaways Podcast, which features short memorable conversations with the world's best thinkers, business leaders, writers, politicians, scientists and other newsmakers. Each episode ends with the three key takeaways that person has learned over their lives and their careers. And now your host and board member of schools at Harvard, Princeton and Columbia, Lynn Thoman.

Lynn Thoman: Hi, everyone. It's Lynn Thoman. Welcome to another episode. Today I'm excited to be here with Pete Wendell. He founded Sierra Ventures, a leading Silicon Valley venture capital firm and serves as a board member of Merck. He has also served as Chair of the board of Princo, which manages Princeton University's endowment. He co-teaches a course on venture capital and entrepreneurship at Stanford with former Google CEO, Eric Schmidt. I'm excited to get an inside perspective on venture capital and find out how easy it is for start-ups to get funding and grow to become unicorns, that is, to become a start-up valued at over a billion dollars. Unicorns used to be rare, but now there seem to be a veritable herd of them. Pete, welcome and thanks so much for our conversation today.

Peter Wendell: It's a privilege to be here.

LT: Pete, let's start with a very basic question. What is venture capital?

PW: Venture capital is a high-risk, long-term equity investment in a company. So let's parse those words. It's high risk because most of the companies or entrepreneurs that get venture capital couldn't possibly just go to a bank and get it. It's not an enterprise that would qualify for a traditional capital, so it's a high-risk enterprise, and it's a long-term investment, typically, because the average company that receives institutionally-backed venture capital, it would typically be seven or eight years before that company gets to some sort of liquidity event, an IPO [Initial Public Offering] or a sale. So this is not a stock you buy in the morning and sell in the afternoon as you're in it for the long haul. And the last descriptor I had there was, it's typically an equity investment, that is, you invest in the ownership of the company and the venture capital investor receives back for his or her money an ownership stake. So their fate and the entrepreneur's fate are now linked for life. If this has a good outcome, everyone's going to get rich, and if it has a bad outcome, everyone's going to lose all their money or, in the case of the entrepreneur, his or her time. So it's a high risk, long-term equity investment.

LT: So Pete, you've been pitched thousands of times, maybe even 10,000 times. You turn down most pitches. How does someone get you to back their start-up? What makes you say yes?

PW: That's a great question. With institutional venture capital, and again, I distinguish institutional, that means it comes from a venture capital fund, we're a firm that does this professionally rather than something that comes from some rich doctor up in Scarsdale who puts out $25,000 a year to someone who strikes his fancy. But for institutional venture capital, we do get pitched thousands of times a year, and the biggest thing that tends to separate wheat from chaff is the size and scale of the opportunity. Most people who are thinking of starting a business have given it some thought themselves. Their ideals have some viability. They have talked to their girlfriend or their boyfriend, they have talked to wife or their husband, maybe they got some additional money from one of their relatives, they're not totally insane when they walk in the door. But the point of differentiation is that some people who seek institutional venture capital have a really big idea, something that if it works, and as we'll talk often they don't work, but if it works, it can produce a great big company, the kind of unicorn that you alluded to in your opening comment.

PW: Because for venture capital firms, they now have millions of dollars, they have tens of millions, hundreds of millions, a couple of venture firms even have billions of dollars of cash. They have to put this cash out to ever make a return. Just because you invest it doesn't mean you'll make a return, but if you don't invest it, you'll never make a return. So they have to invest large amounts of capital, and they're only going to own part of the company for making this investment. So if they're going to put tens of millions of dollars into a company and still only own part of the company and they're going to get a big return on their investment, the company itself has to grow very large. And the biggest point of differentiation between most deals that a venture firm funds and those they don't is they fund the ones where at least some of the partners at the firm are intrigued that there is a path, there is a scenario to create a great, big hulking success out of what they have just heard.

PW: So when you pitch a venture capitalist, it's all about getting him or her to really let their excitement and greed overcome their fear. Because you listen to any of these pitches, you're going to have a certain amount of fear that it's going to crash and burn and are taking enough risk if you didn't. But what the entrepreneur is trying to do with to venture capitalist is to get his or her greed, their anxiousness for success to overcome the inherent fears and risks associated with any of these things.

LT: It sounds like it's the idea that is the most important thing, it's not the experience of the founder or the background of the founder.

PW: Well, those things can certainly be important. There is a big debate in the venture capital world, we teach about this at Stanford, about whether the winner of the race is the best horse or the best jockey. Okay, the horse is the idea, it's the essence of what they're trying to do, it's the concept, it's what looks big and really interesting. The jockey, not some men and women driving the horse, that's the management. A lot of venture capitalists are jockey betters, they say, "I'm just going to bet on great people because great people, they find the oxygen in the room, they find the big ideas, they find the unicorn. I'm going to outsource that to the management to do all that." But a fair number of people in the venture capital business tend to bet on the horse. They say, "Listen, give me a big idea that where the timing is right, this could really be a hit and we'll get the right people to run it." If the person who pitched me just didn't seem like they were going to take this the distance, then so be it. If it's as big an idea, and as much a success as I think it's going to be, I'm a venture capitalist, I got a big Rolodex of entrepreneurs, I teach at Stanford, I've had two or three thousand former students, I can get someone great to come in and run this. Just give me an opportunity that's unstoppable and huge.

LT: You mentioned eight years as the term of many of your investments, what is the relationship like between a venture capital firm and a startup that it funds?

PW: First of all, it's pretty enduring relationship. If you're a startup founder, as I'm sure many of your listeners are, if they hire, their accounting or audit firm and they don't like them, they can fire them. If they hire a law firm and they don't like the advice they got, they just pick another law firm.

[laughter]

PW: A venture capitalist is scotch tape. It's more like fly paper. Once you sell a venture capitalist a sliver of your company, you're not getting rid of them any time soon. Okay, so that's why I say, "Hey, this is a long-term relationship." The learning in that, for the entrepreneur, is you don't want to think too transactionally when you're dealing with your venture capitalist because you may get the better deal in the first round of financing, or you may get your way with regard to doing X or Y, but you know what, the sun is going to come up and it's going to set for seven or eight years on that relationship. So you really want to think in the long term. So the first thing about the relationship between an entrepreneur and a venture capitalist is that they tend to be long-term and enduring. Secondly, they're really symbiotic, they both need the other and hopefully, they're quite synergistic. A good venture capital firm has backed hundreds of companies, a fair number that have become big successes. The mere fact that that venture capital firm would invest in the venture is a certain imprimatur on the venture itself. Then what comes with the investment is a partner and a team from the venture firm who helps the entrepreneur be successful, make no mistake, the venture capitalists are the stage hands, the entrepreneurs are the actors.

PW: Our job as a venture capitalist, feed them the line when they're about to miss it. Get them a contact with this firm, find them another investor for the next round, get them their first big customer. Venture capitalists are here to help and support. They also typically have a governance role, usually the lead venture capitalist will serve on the entrepreneur’s board of directors, so there's somewhat of a formal governance relationship too, but mainly the best relationships are those where the entrepreneurs and their venture backers are in the trenches together, building value over a long period of time so that they share in a mutual success.

LT: About what percent of companies do venture capitalists invest in make money?

PW: The short answer is pretty low. The academic studies that have been done across a wide number of venture firms over wide periods of time suggest that most institutional venture firms make 90% or more of their return on about 12-15% of their investments. Now, I should tell you, my wife constantly counsels me to just do those deals, and to be home for lunch every day. But unfortunately, you don't know when you're doing them which bucket they're going to fall in. But the direct answer to your question, Lynn, is that it's a reasonably small percentage, probably in the teens somewhere, that produces a vast majority of any profit.

LT: For the 80-85% or so, of the startups that fail, what are the most common reasons that they fail?

PW: Again, if you look at the academic literature, which has polls on venture capitalists about why their companies fail, what do you think the venture capitalists say? They say, "Oh, it's because of the management." But actually, I don't think that's true. I think failures... And there's a great new book that we just used in our course this year, I'm not plugging this, I'm not getting royalties, it's called "Why Startups Fail." It's by Tom Eisenmann at Harvard Business School. He did a very systematic set of research and came up with far more interesting answers than venture capitalists think the management didn't do a good job. First of all, there's the issue of timing. Some companies that we back are too early. I mean, they have a great idea, but how many artificial intelligence companies were back 20 years ago when AI was a glint in the eye and they churned through a lot of money. How many robotics companies were backed in the '80s and the '90s when robotics were still too primitive to really be effectively commercialized? So sometimes they're too early, sometimes they're too late.

PW: How many AI companies are there now? Hundreds. Does the world really need the 102nd AI company? So first of all, it's getting the timing right. Not too early, not too late. Another important contributor to things not going well is how the competitive landscape rolls out. Some opportunities are best pursued by great big companies, because they already have a customer base, they have the sales force, they have the resources. So often, when we look at an entrepreneur pitching us, we say, does that person have an interesting company? Or do they have an interesting product? They're coming to us with an interesting idea, but this is really going to be a product in the Procter & Gamble product line or in the Google set of offerings. So some things are very interesting, but it goes back to this notion of not being big enough as a platform to build a big success around. They're more niche products, and not big platform ideas. The men and women involved do play a role.

PW: We've all had executives that we've worked with or for, or have worked for us, where they just weren't a good fit. And a lot of people in life aren't a good fit, but usually, it's the ability to correct us quickly. So you hang with management that's not doing so well quickly and had you changed the management... The small entrepreneurial companies change those very quickly, and they have a limited time to catch their wave and ride it to shore. So you can't mess around with hanging too long when the team isn't working or the people aren't working. So people is a reason for failure on some occasions, but often it has to do with the timing, too early or too late, trying to catch the wave. Often it has to do with the scale of opportunity and whether this would have been a good product in a big company rather than a standalone company by itself. And thirdly, it does sometimes have to do with the men and women who are in management.

LT: If only about 15% of investments are profitable, you must look for enormous returns on those investments. What kind of returns do venture capitals look for on their investments?

PW: Big.

[laughter]

PW: And again, 15% make the material profit that drives the fund. If you actually do the accounting in the books, probably more like 30 or 40%, should make some profit. But again, this is an eight-year investment, you put in $5 million, and you get back $6 million, you would have been better in US savings bonds. But I'm just saying it's a teen percentage that materially moves the portfolio, that accounts for 90% plus of the profit, but that's not saying that some of the other ones aren't "profitable investments." So just to clarify that a little bit. But as for your question of how big a return do you want? The short answer is if you're doing early-stage venture capital, you have to see a credible scenario to make at least 10 times your money. That's a floor. Okay. Now, obviously, do they all make 10 times your money? No, I just told you most of them don't make next to anything.

PW: But for the ones that work, you want to be able to hopefully make 20, 30, 50 times your money. At Sierra Ventures, our early investment in Intuit came to be worth about 200 times what we paid for it. Our early investment in Teradata became worth something like 100 times what we paid for it. So if things go right, they have to really go right. Because remember, for every 10 deals in the portfolio, at least five are going to be wash-outs. You got three or four where maybe you'll make a little bit, and then you got two who are going to do all the heavy lifting. So by definition, if you're going to double your money in the fund and only two deals are going to do the work, those two deals each have to make like 10x to get the money back. And all that does is double your money, which in six or seven years doubling your money is interesting, but not a reason that you would tie it up in a venture capital.

LT: Wow. If you step back and look at overall venture capital industry returns compared, for example, to the NASDAQ, which is the US stock index that is heavily weighted toward technology, how do those returns compare?

PW: Well, like anything, it depends on the time period you look at. But looking at long data sets over 20, 30 years... It also depends which part of the venture capital industry you look at, because while the NASDAQ is a singular index, in venture capital, there's a much wider dispersion of outcomes between the top quartile funds and the rest of the industry. For example, there was a 10-year period where the top quartile funds made all the money that was made in the venture industry for 10 years, was made by about a quarter of the funds.

PW: Because if you think of it, given the fact that successes are few and far between, but they're huge when they occur, if those successes are spread somewhat unevenly across the better venture firms, then you really don't look at just a run-of-the-house set of venture firms, because there you would see that over again, 20, 30-year period, if you just had a run-of-the-house set of venture firms and you compare it to the NASDAQ index, there might be about a 300 or 400 basis point outperformance, three or four percentage points, which compounding over 20 or 30 years is not immaterial, but it's not usually exciting. But if you look at the top quartile venture funds, and you obviously just keep the same top quartile, although you don't always substitute it, you do an honest statistical comparison and you keep top quartile for 20 years, that's going to perform than the NASDAQ index by 10 whole percentage points, a thousand basis points, 10 whole percentage points or more.

PW: It's very immaterial, but those top venture funds, anybody just can't walk up and say they want to be an investor in those. It's not lost on the rest of the world what it means to be tied up with a good venture fund. So the short answer to your question is there is long-term out performance in return from the illiquidity of being a venture investor, but you really have to work to get in the better part of the venture industry because there's a lot of venture capital firms that you really wouldn't bother based on the returns.

LT: Interesting. 2021 has had a record number of venture capital deals and startups valued at over a billion dollars, so-called unicorns. The unicorns used to be rare, but now there seem to be a whole herd of them. Why is that? Are people smarter, is it easier for startups to grow, what's going on?

PW: First of all, 2021 has been a very big year for all types of venture investing, so yes, there's a lot more unicorns, and yes, there's a lot more money floating around, but the overall velocity of investments, good, bad, and unicorns vary substantially from two years ago, which is a big surprise, who would've thunk during the pandemic... But actually, like everyone else in the world, venture capitalists have found a very efficient way to do their business over Zoom and they have raised their velocity. But as to your question of why this rapidly expanding huge herd of unicorns is here, I think there are several factors. One is that the valuation that investors in all asset categories are willing to pay, not all, but many asset categories has really risen like a Helium balloon. Look at the DOW being at an all-time high, the NASDAQ being at an all-time high. So the valuation professional investors are paying for many assets is certainly at all-time peak, that helps create more unicorns.

PW: Secondly, there's been a much greater concentration in how venture capitalists have been investing for the last three or four years. A lot of these markets are winner-take-all markets. So when the venture capitalist sees an existing venture-backed company that's had two or three rounds of financing, that's looking very promising, that looks like it's going to be the winner in the field, then the money pours in. Look at Uber as an example, how many ride sharing services in a given city or you're reasonably going to... Maybe you're going to have two or three or four, but you're not going to have 20 different ride sharing apps on your phone. The winner is going to take 50% of the market, the second place maybe take 30% of the market, and then there'll be fragmentation. A lot of these growing, burgeoning tech markets are winner-take-all markets. So as soon as a venture capitalist get a sense that a company is really moving along, now this isn't the first time the entrepreneur ask for capital, this is for the D-round or the E-round, the so-called Fear Of Missing Out, the FOMO.

PW: Fear Of Missing Out starts to overcome the venture capitalist and they become less price-sensitive and more just wanting to be in the deal, I want that deal on our firm's marquee. So one, there's been a high flow of capital in general coming into VC for the last couple of years. Two, most invested asset prices are at a near all-time highs. Three, capital is getting more and more concentrated into fewer and fewer gills. And the fear of missing out on a real winner has set aside the valuation discipline, which was present for several decades.

LT: What areas are hot right now?

PW: A lot. Again, it's the answer just cause there's so much venture investing going on. But as I was alluding to earlier, artificial intelligence and all things AI, areas of great interest and areas of huge leverage, because artificial intelligence is about machines learning, making adjustments, learning some more and has infinite leverage. You don't need a lot of people, you just need programming. And so AI continues to attract a lot of dollars. Obviously, in the last 12 to 15 months, Lynn, all of life sciences has gained much more interest. Historically across the professional venture spectrum, Life Sciences were 15, maybe 18% of the dollars. Most of it was in technology, software or other technology, but now life science is more like 25%, 30%, and there's huge unmet medical needs in the world. We saw some obviously in the last year or two with the COVID vaccine. But more generally, conditions like obesity, Alzheimer's, there's these huge negative health impacts that affect tens of millions of people and helping to solve, cure, or at least control some of those, very large opportunity.

PW: I alluded to robotics earlier. Robotics, people think of a Detroit factory and so-forth, but actually there's so many things that can be done robotically and not by humans. And particularly as labor pools have really dried up and some people saying well, it's temporary dislocation because of the pandemic, but in my view, a lot of people are reassessing what they were doing with their life and saying, "You know, I'm not going to be a bus boy in for the next three years in a restaurant," or "I really don't want to be a short order cook." Now, I'm not sure either of those jobs can be instantly replaced by robots, but I'm saying the economic interest in doing so has gotten higher as labor shortages look like they're not going to just be ephemeral, but they're going to be potentially permanent in many jobs. So I think those are all areas where venture capitalists are scratching around.

LT: And what are you most excited about?

PW: As you mentioned at the beginning, I've been a long-term member of the board of directors of Merck, and I've seen what medical innovation can do for customers and for the world. I do think the strides in biotechnology, in RNA, I think we have very exciting times coming in the next 10 to 20 years in life science, and I just hope we all live long enough to benefit from them.

[laughter]

PW: We all just have to hang in there another 10 or 20 years. But I'm very excited about the life sciences side of things, and also generally in the big data space, the world is generating exponentially more data every year, and now with artificial intelligence, you can mine that data, you can have insights to it, so things in the big data and where big data meets AI, those are very interesting and exciting spaces to me.

LT: Pete, if I can ask what are the biggest mistakes you've made?

PW: Oh my goodness, we don't have long enough on the podcast [chuckle]

LT: I don't believe that.

PW: But if I were to think of them categorically, I think sometimes, I didn't think big enough. The best entrepreneurs think hugely big. And venture capitalists can sometimes see themselves as the bumper rails, and really, the most effective venture capitalists learn to think bigger and unconstrained. One of the very famous venture capitalists who comes to our class at Stanford, who will go unnamed has a quote every year, where they say, almost anyone that I've made a lot of money with, almost any entrepreneur that was really successful, it always seems like they kind of had a screw loose, there was a screw loose somewhere, but you have to have tolerance for people who kind of have a screw loose somewhere. Look at... And again, these are famous people, so I'm not trying to diminish them in anyway.

PW: Look at Steve Jobs' interpersonal behavior with many people. Look at Elon Musk's behavior with many people. Elon and Steve were and are fantastically successful entrepreneurs, but the venture capitalists who backed them were on the guardrail duty, and you can mentally get yourself on guardrail duty, and in the entrepreneurial world, you don't want to be that way. You really want to think as expansively as the men and women that you're backing because that's how you'll get the biggest results.

LT: So interesting. Before I ask for the three takeaways you'd like to leave the audience with today, is there anything else you'd like to mention that you haven't already talked about, did we leave anything out?

PW: Nothing other than both entrepreneurship and venture capital are really fun and fulfilling life experiences, they're not without frustration, a lot of things go wrong, but it's always about the next biggest thing, it's always about tomorrow, it's always about what could go right? And I hope those that listen to your podcast think about applying their skills in these fields, because generally, a lot of really interesting companies have been created that were not just profitable, but they were game changers for a lot of humanity. So I hope people will realize this is a really interesting area, and again, you're great to have me on your show today.

LT: Oh, it's my pleasure, Pete. What are the three takeaways that you'd like to leave the audience with?

PW: Well, if I think about what we have just discussed, I think most of my takeaways would be directed toward your entrepreneurial audience, because you probably have a lot more aspiring entrepreneurs than venture capitalists who would listen to this, and I think one important takeaway is to really try to get yourself in relationship with financing sources and venture capital sources that can really be effective long-term partners as you try to grow your company. A lot of the contemporary wisdom, our own venture capital comes from The Apprentice and these shows where someone says, "Alright, I'll give you a million dollars for 30% of your company" and the entrepreneur says, "No, I'll only give you 20% of the company for that." And there's a lot of back and forth between the financing source and the entrepreneur about how much money should buy how much of the pie.

PW: There's only 100% of the pie and what sliver is going to go to the money and what sliver is going to stay with the entrepreneur? That's not the important thing. The important thing is the entrepreneur getting in relationship with venture capital backers who can help them grow the pie, so the pie gets so big over five or 10 years that it doesn't matter the exact angle you had, because there are so many more square inches in your slice of pie, because that pie got so big because you really got a great financial partner who had a lot of experience to help you build the business. So the first take away is don't be too precise how you negotiate a deal because it's more about finding the right partner who you're going to be living with for a long time.

PW: I think the second big takeaway for entrepreneurs is that they should be very cognizant of the dissymmetry of information between themselves as entrepreneurs and the venture capital backers they choose. So when it comes time to do a deal and say, alright, how much money will buy what percent of the company and what are the terms, and how many board seats are controlled by who, that's going to be a negotiation that the venture capitalist has done tens of times, or maybe even an old guy like me, a 100 times, alright? So some entrepreneur, he or she, they're doing like their third financing ever. There is a huge dissymmetry of information when venture capitals and entrepreneurs do deals together, and the smart entrepreneurs get help. They get a law firm that does a lot of venture capital deals, this is a specialty area of law, you don't hire the lawyer who did your parents' divorce.

PW: I mean if you're going to get a lawyer, get a lawyer who does a lot of these transactions and can even the dissymmetry, because there's going to be a real experiential dissymmetry between the knowledge from the entrepreneur and the knowledge of the venture capitalist when it comes to doing venture capital transactions. So the second key take away, is get help when you first start to find a venture capitalist you like and you're trying to nail down or deal with them. I think the third takeaway is just to try to keep things simple, keep things simple in how you do your financing, not too many bells and whistles and, gee, there's a special preferred term that if this happens, then I get that, but if that happens, then I get that. The opportunity is over and you're still negotiating the deal. Just find a reputable, trustworthy source of capital that's built a lot of other successes.

PW: The entrepreneur should reference the venture capitalist as much as the venture capitalist is referencing the entrepreneur because of this fly paper sort of relationship they're going to have. And then just keep it pretty simple and fundamental and focus on building your company, not on the last bells and whistles in some financial deal that's for the first couple of million dollars of capital.

LT: Pete, this has been wonderful, thank you so much.

PW: I'm glad we had a chance to do this today. And again, it's an honor to be on the show. Thank you very much.

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