# LPs Cautioned Over 'Brand-Name' Firms' Drawbacks

**By Zoran Basich, Private Equity Analyst**

6/19/2008 -- As the outsize returns that typified 1990s-vintage funds become the exception rather than the rule in the venture capital industry, some advisers and limited partners say they are increasingly looking to younger, less established firms rather than the established VCs that made their names during the tech boom.

"One of the biggest mistakes LPs make is trying to buy a brand. It's absolutely the wrong way to go," said Robert "Mac" Hofeditz, a partner with Probitas Partners, at the International Business Forum Venture Capital Investing conference in San Francisco last week. "Brands don't earn investors returns, individual GPs do."

Hofeditz, whose firm raises capital and acts as a placement agent for institutional investors, says he is "aggressively bullish" on venture capital, seeing the current period of relatively low returns and soft LP demand as a buying opportunity. "Historically, it's the best time to buy something when asset classes are beaten down."

However, he said his due diligence increasingly is pushing him toward younger, emerging teams rather than "brand-name" firms, which he declined to name.

"We've seen brand-name firms, but after spending time with them, I just couldn't get comfortable," he said. "They weren't passionate – they were just raising a fund because that's what they do."

The tendency of established firms to become complacent is hazardous to investors, agreed Alex Bangash, managing director of the Rumson Group, an LP advisor and fund-of-funds manager.

"Firms cannot rest on their laurels," he said. "The emerging managers are closer to the entrepreneurs. The entrepreneurs are where it's at. If you're not close to them, you're losing deal flow...New funds, new geographies and new sectors are coming into being."

Hofeditz said some of the newer technologies may be passing the established firms by, and suggested generational issues play a role.

"A lot of entrepreneurs don't want to deal with partners 20 years older than them," he said. "They don't understand them, they don't speak the same language. That's why nontraditional groups are beating the established firms on hot deals right now."

Another panelist at the conference, CDIB Capital Executive Director Howard Lee, gave generational issues less priority when doing due diligence. "You don't have to be a 25-year-old expert on social networking to be able to identify a good deal," he said.

Two of the firms cited by Hofeditz as emerging firms were Shasta Ventures and Emergence Capital Partners. Shasta, operated by managing directors who were formerly with Trinity Ventures, New Enterprise Associates and Battery Ventures, closed its second fund at the hard cap of $250 million last November. Formed in 2004, the firm saw exits last year from its $210 million inaugural fund when Hewlett-Packard Co. bought Logoworks for an undisclosed price and Opsware Inc. acquired iConclude Inc. for about $53 million in cash and stock.

Emergence, which formed in 2003, closed its second fund last May at $200 million, above the $175 million target. To promote confidence in its investment strategy, as one of their first investments the firm's general partners used their own money to invest in Salesforce.com Inc. prior to its successful 2004 IPO.

The relatively modest fund sizes of those two firms are keys, Hofeditz believes.

"Venture capital is going through a significant transformation, and a lot of people are missing it," he told VentureWire in an interview. "Big funds are not necessarily good for LPs. If you've got an $800 million fund with a five year lifespan, you've got to put out a lot of money. If you're expecting 4x or 5x returns, then you're talking about turning that $800 million into $4 billion. The math just doesn't work. It's easier to turn $200 million into $1 billion."

In May, Lightspeed Venture Partners closed its eighth fund at its hard cap with $800 million in commitments, and firms such as Bessemer Venture Partners and Technology Crossover Ventures have raised mega-funds in the last year.

Succession issues at some established firms also could wind up biting investors, Hofeditz said at the conference. "The average lifespan of a venture investor at a firm is seven years. These are three- or four-year

funds. A lot of LPs are going to be left holding the bag because the guys they invested in are no longer there. You'll see that become an issue in the next couple of years because these guys are not getting younger."

Bangash agreed that part of an LPs' due diligence should be to look into a firm's succession plans, and also to be on the lookout for turnover. "You have to tap into the grapevine to see if there is a partner looking to join another firm."

But Bangash said personnel changes sometimes receive too much emphasis. "Sometimes turnover is good, such as when a partner is not performing," he said.