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Founder or investor, who should be the 'keepers' of an enterprise?

By G.Sabarinathan| Aug 22, 2022

Founders running crazy to achieve growth at all costs is not new to the world. But the investors in these companies are equally answerable. Here's how

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VC fund manager has to oversee a large number of investments at a time Image: Shutterstock

This is a response to an article that appeared in a leading national daily which seemed to cast the responsibility for the recent unsavoury developments in a few startups on their founders. Founders running crazy is not new to the world of early-stage investing. The question is who is to be held responsible for their alleged misconduct. Founders? Investors? Both?

THE VENTURE CAPITAL MODEL – AS IT WAS INTENDED TO BE

To answer this question, one needs to delve into the genesis of the venture capital (VC) industry.

The economic rationale for VC fund-managed rests on three premises. One: VC fund managers have the intellectual and social capital to seek out and evaluate a large number of investment opportunities. Two: they invest in a small number of select businesses based on a sound appreciation of the risks and rewards inherent in those investments. Three: This is a key distinction for this discussion—they have the organisational and individual capability to manage risks in their investments through active engagement with those enterprises.

The third one of the above considerations is paramount. The entrepreneur who raises VC may be an expert in his chosen field of business or technology, but then he needs a lot of guidance, support and oversight as he grows the enterprise. And that is the critical value that the VC fund manager is expected to add.

VCs raise funds from investors who look up to the VC fund manager to deliver attractive returns by performing those three sets of tasks, which the investors may not have the capacity to undertake on their own. In return for their services, VC fund managers receive a fixed management fee that amounts to 15-20 percent of the fund's investment corpus and 20 percent of the capital appreciation from the investments. By way of comparison, investors in actively managed mutual funds incur a cost of not more than 3 percent of the assets under management.

THE VC MODEL – A CONTEMPORARY VIEW

Are managers legally or contractually empowered to perform their role? The answer is absolutely yes. Contracts that VC fund managers enter into with their funded enterprises give the former the power to influence not just the strategic aspects of the enterprise but even the operational aspects. Some observers consider those powers even draconian.

Are VC investors then playing their expected part? Given the relatively low level of transparency in privately owned enterprises, it is hard for anyone who is not an insider to the investment to have an informed answer to this question. To a certain extent, the answer to this question lies in the article in reference.

It has to do with the fact that VC fund managers oversee ten or more investments at a time. The traditional wisdom in VC fund management recommends that fund managers do not oversee more than five funded enterprises at a time if they are to devote meaningful attention to them.

IT IS ALL ABOUT INCENTIVES

Why do fund managers oversee more investments in practice, as the article seems to suggest? That has to do with the economics of fund management. The good old model of VC was that the fund manager earned just enough fixed fees "to keep the lights burning." They got their financial upside from the returns they generated for their investors.

In the contemporary world of VC, fund managers seem to get wealthy from their fixed fees by raising more and more funds that are ever-growing in size. That goal defeats the idea of aligning the financial

incentives of the fund manager with that of investor returns; because fund managers are now chasing fees that are independent of the returns they deliver. The profit share is just the icing on the cake.

ERRORS OF OMISSION AND COMMISSION?

The contemporary approach to investing appears to be about finding the right founding team, throwing a huge slug of cash at them, and then cheerleading their competitive instincts as they chase growth at all costs—even if it is not profitable. That is a natural approach to follow if the VC fund manager has to oversee a large number of investments at a time.

If the inability to oversee governance in a funded enterprise is an error of omission of sorts, the recent press stories suggest that there may be an error of commission as well, on the part of the VC fund, although that may be hard to prove. Investors seem to egg startup founders on to the pursuit of hypergrowth, at all costs, because their investment funds have a predetermined period within which they have to harvest their investments.

It is tempting to paint the erring founder as the villain of the piece behind the stories of poorly governed startups that have emerged lately. But, as I argued elsewhere, the investors in these companies are equally answerable. To adapt from an old children's story, he who pays the piper must call the tune. The responsibility for good governance rests equally on both founders and investors. How else does one justify the handsome fees that VC fund managers charge?

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