Constellation
VMS Ventures

April, 2022

Case Study:

On why VMSV uses preferred instruments when it invests

A largely unmodified email conversation with a Portfolio Manager about why VMSV uses preferred instruments when it invests. Where text has been excised (largely to protect the innocent, or to make me look less draconian) I've used "..."

From: Portfolio Manager

How is VMS Ventures going? I've been going back and forth with Karl as we were evaluating a company [a potential investment outside of CSI]. I suggested some tweaks to the Term Sheet as I had some push back when it comes to the liquidation preference.

From: VMSV

With your background in the VC business, you know the economics of venture capital: a small percentage of high return exits and a large percentage of failures. Think of the IRR probability distribution as highly skewed to the left with a long right tail.

VMSV chops off the long right tail by only investing in small TAM businesses (we work in niche verticals), and by holding them forever. It is incredibly difficult to generate high returns forever, because such businesses attract competition (often irrational competition).

So if we cannot count on the huge returns from right tail investments, then we have to do better on the wipeouts, walking wounded and modest wins. We do that by getting our cash out first and then splitting any subsequent return above the risk free rate with the entrepreneurs. That's not entirely true, because our entrepreneurs will be taking reasonable salaries all the way along the journey, so they are really the ones getting value first.

Preferred instruments were historically how all venture investment was done. The cash invested got a liquidation preference, and the entrepreneurs got a big chunk of the upside after the investment was returned. Competitive rivalry amongst VCs has driven some of the preference structures out of the market.

I gather that you think VMSV will be uncompetitive if we use a preferred instrument. I'd also point out that we will never sell, so that also makes us uncompetitive. There are likely many other elements in our term sheet that will make us uncompetitive... with what most VCs are doing.

Most VCs are targeting large TAMs. Most VCs are targeting companies that are sold in 5-7 years to strategic buyers. We are targeting neither of those situations. We are targeting the tiny subsegment of entrepreneurs that want to create great little business in which they can work with their handpicked teams for the rest of their lives, servicing a loyal group of customer/partners. This is a very difficult concept for most people to understand.

I'm not naïve. Nearly all entrepreneurs occasionally permit themselves to dream about being billionaires with no responsibilities, having flipped their start-ups to Google or Facebook or strategic buyer ABC. We want to back entrepreneurs who are mature enough to know that the probability of that outcome is zero given the businesses that we are backing.

From: Portfolio Manager

Now, when it comes to VMSV I fully get your point. I guess that, as with the original CSI model, VMSV will also be attractive to a subset of companies and not the broader market. From my interactions with Karl/Daan and on the one example of XYZ Software, I understood the following:

1. We make it easier for the founders to focus on growth as they will not have to fundraise from new investors every 18 months.
2. We give them a longer "runway" as we will not seek an exit.
3. We will support them with the operational excellence of CSI.
4. They will have access to all the learnings from the entire portfolio - a true value add.
5. Our "ask" is, that once the company is in a position to pay out dividends, they should pay us back first and then continue to distribute profits on a pro-rata basis.

The pushback we got from XYZ Software was in relation to the "preference" on the dividend pay out. ...

Mark, to be clear, I don't see us even competing with traditional VCs as VMSV is addressing a subset of the market where traditional VCs will most probably never engage. ... What I do believe is that we just need to focus more on finding the right venture capital opportunities. Given my background I keep coming across some of them in my pipeline ...

From: VMSV

If XYZ management do not think they can generate at least the risk free rate of return on VMSV's capital, then we should not be investing. If they do think they can beat the risk free rate, then we are delighted to give them a disproportionate share of the upside.