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Venture Capital is Gated Capital

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Bessemer Venture Partners operating partner Jeff Epstein explains the venture capital funding model as a kind of natural selection process. Funding gives companies a chance to prove themselves, but if they can’t prove themselves within a year or two, they are quickly weeded out. The winners, meanwhile, make it through the next gate and are given a chance to prove themselves on a larger scale.

Transcript

Jeff Venture capital is gated capital, 00:00:04,160 meaning there's a gate and you have to go through the gate to get to the next round.. So the venture investors would give the founders one to two years worth of capital, just enough to get to the next gate.. Now, this footnote here says, except in 2021, what's happening right now is investors are giving venture capital backed companies enormous amounts of money, tens of millions, hundreds of millions of dollars, that they're not going to spend for the next year or two.. And so we're in something that's very unusual.. We'll have to see how the industry responds.. But, I would say, for the last 20 years, this idea of gated capital has been the normal paradigm where the company only has enough capital for a year or two, and has to make a lot of progress during that year or two.. We'll come back to this in Q&A, about what the 2021 market environment is like.. So why does this system work? Well, it's worked in the natural world for a long time and scholar, Charles Darwin, came up with the idea of natural selection, and, fundamentally, that happens with venture-backed companies.. You have 12,000 venture capital companies funded every year.. They're not all gonna make it..

Some of them are gonna go out of business.. Some will merge with others.. Some will just return some amount, 50 cents of the dollar or a hundred cents of the dollar, after only a couple of years.. And so this concept of natural selection, it works very well in the world of biology, it also works very well in the venture capital world.. So what happens if you don't make the progress? You raise your first round of venture capital, or your second round, you're not doing very well, you're not growing, you're not reducing the risk for the next round of investors.. What happens if you can't raise any more money? What do you do then? Well, you're losing money.. You can't raise more, and you only have one of three choices.. Cut costs.. If you have some revenue to get to break-even.. Sell the business for whatever you can get, or shut the business down..

And this discipline of having to prove something, within a year or two, until your cash runs out, is an important reason why the venture capital process works well...