Atas VC Whitepapers

The Next Generation of Venture Capital

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Venture capital is at a crossroads. In this article we outline the necessity and implementation of a new generation of VC.

Venture is Changing.

I do not think I have to explain the broad level of change the world has gone through since venture capital first "officially" emerged in the late 1960s/ early 1970s.

Although even though we live in an era of great change, the model of venture capital, the funding mechanism that propels this innovation, has not changed really at all. Sure, valuations aren't remotely what they used to be. But really since the widespread adoption of the 2 and 20 model in the late 1990s, and the emergence of the YC SAFE, the structure of venture capital really has not changed too much generally either. And even those "revelations" are really minor in the grand scheme of things.

I am a young venture capitalist, but I come from a different background, a scientific background. Prior to being in venture, I worked at NASA JPL writing software to model icy ocean world interiors. In science we're always pushing the envelope for innovation, and always driving ourselves to operate in better, more efficient, and more accurate ways. When I first joined the industry, I was appalled that an industry that adjoins technology so closely is itself so antiquated.

Whether that's from the lack or poor quality of software/tools used or to the underwriting styles that can no longer keep up with modern technology or business ideas, venture capital itself is an old industry, just like agriculture, or construction, or mining.

My career goal is to, at least in my ecosystem, drive forward the development of the industry so that it can keep up with technology. The next generation of venture capital will be driven by eventual shifts in the industry that require cultural changes and shifts in the industry that require actual structural changes in how fees, rewards, and other incentives operate. Let's start by discussing the latter.

Structurally VCs are incentivized to raise more money, not to make more money. Because the 2% is so aggressive with larger fund sizes, you're far better off raising a $500MM fund with small staff that deploys slowly and makes a 1.5X DPI than you are running a $10MM fund that returns a 5X DPI. This really shouldn't be the case – linear scaling of management fees and carry percentages with fund sizes simply doesn't make sense. Because of this VCs will invest in questionable companies, avoid risk, and find beta instead of alpha so they can continue to raise more funds.

Outside of the structural issues presented here though, venture capital has a broader level cultural issue that has developed as a result of these structures. In short:

Many VCs are Lazy.

Once you make partner, your fundraises are guaranteed, a lot of VCs lose their will to be aggressive and competitive. They'll hire employees but pigeonhole them off so that they never take a significant share of management fees or carry and continue to coast from summer vacation in Europe to summer vacation in Europe until they retire happily. This is the reason for a lack of diversity, groupthink, and misaligned incentives for the industry. If you make the entire industry revolve around relationships and branding instead of returns, you never have to be held accountable for a lack therein. It is a vicious cycle where generations teach the future generations not to rock the boat, and then the whole industry stays complacent with mediocrity.

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Some of this, I don't think you can fix. The old adage "nobody ever got fired for buying IBM" is objectively true. But for more financially incentivized LPs there is a pathway forward to investing in a better version of venture capital. Nepotism will never fully leave the industry; it truly does take money to make money sometimes. However, we can fix the management fee structure. We can fix the wastes of LP capital on fundamentally flawed businesses. And we can fix this industry frequently failing to outperform the public markets.

One of the best pieces of advice that my former managing partner Jim Kim ever gave me was that you can never be smarter than everyone. But you can outwork them. If you combine harder work, greater transparency, and a new level of intellectual honesty, there is no reason this industry can't outperform every single other asset class.

But why even try to change?

Objectively speaking, this industry works for most people. LPs keep deploying, VCs keep raising funds. This past year, versus in 2014 only 243 funds raised capital. In 2022, that was 1,340 funds. The industry has exploded rapidly. And whether or not performance has always backed it up, there's a persisting interest in the industry. So why does anything actually need to change?

For me, this comes down to the concept of striving for perfection. During one of my first few months in venture I heard someone refer to $250K as a small check, as a throw away.

“It’s Just a Throw Away Check”

That has been the sort of language I’ve routinely heard throughout my career in VC. VC needs to change so that the language of check sizes normalizes for those who have money and those who do not. Let me explain when I used to work in a bioengineering lab, the story that I always tell is that my PI at the time would have (likely literally) committed murder for the $250K check that I see VCs routinely throw into companies with fraudulent or near-fraudulent technologies to either raise. Whether or not you care about the actual impact that we could make scientifically or in terms of impacting people, objectively if we invest in real products that real people use and pay for, we’ll generate the financial returns that venture promises. Make the world a better place and generate legendary returns in the process. Create the competitive environment always promised by the American capitalist ecosystem.

Sure, that may be exaggerating a bit, but if that’s the opportunity, I don’t know why we would ever settle for anything less.

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