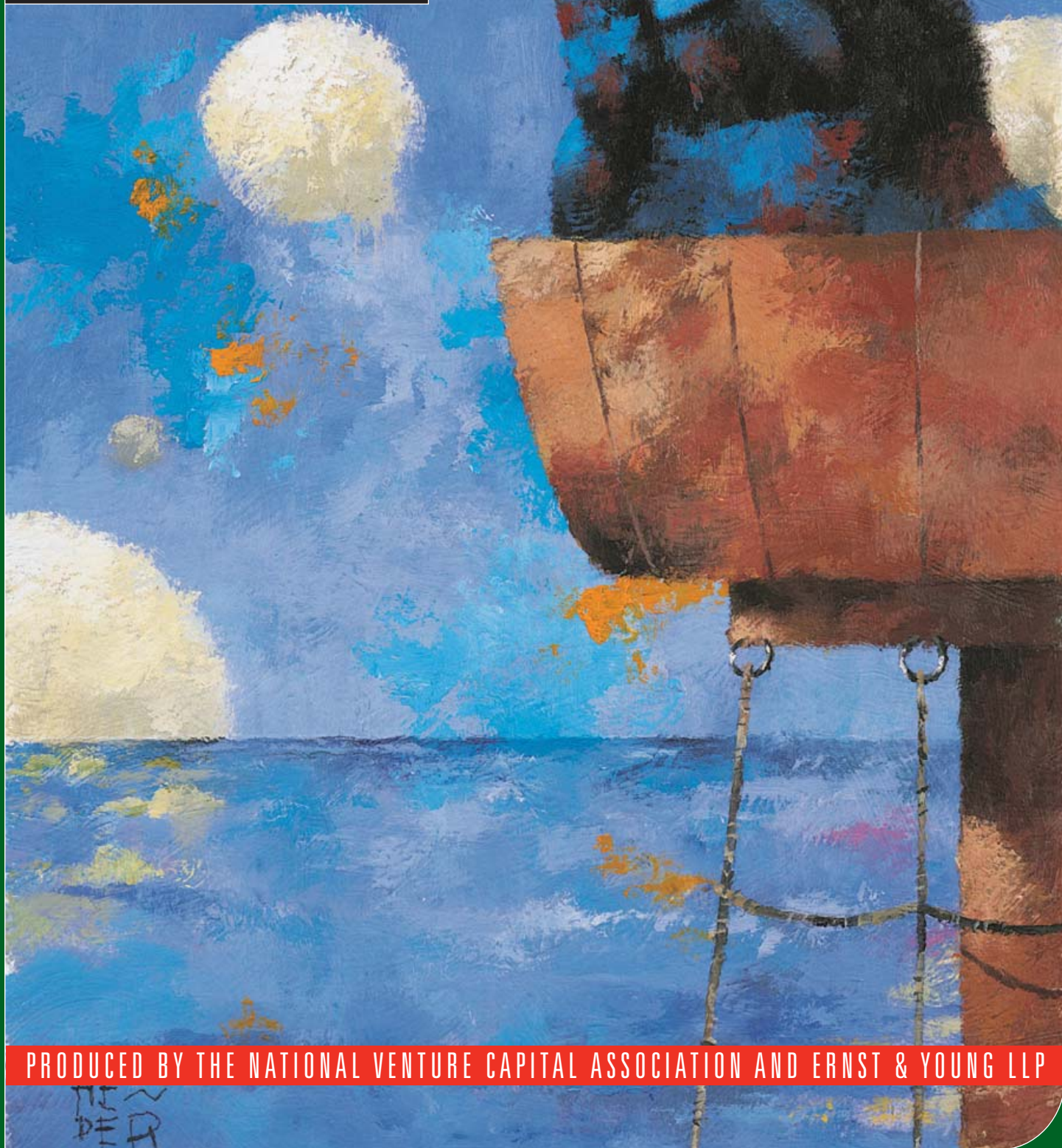


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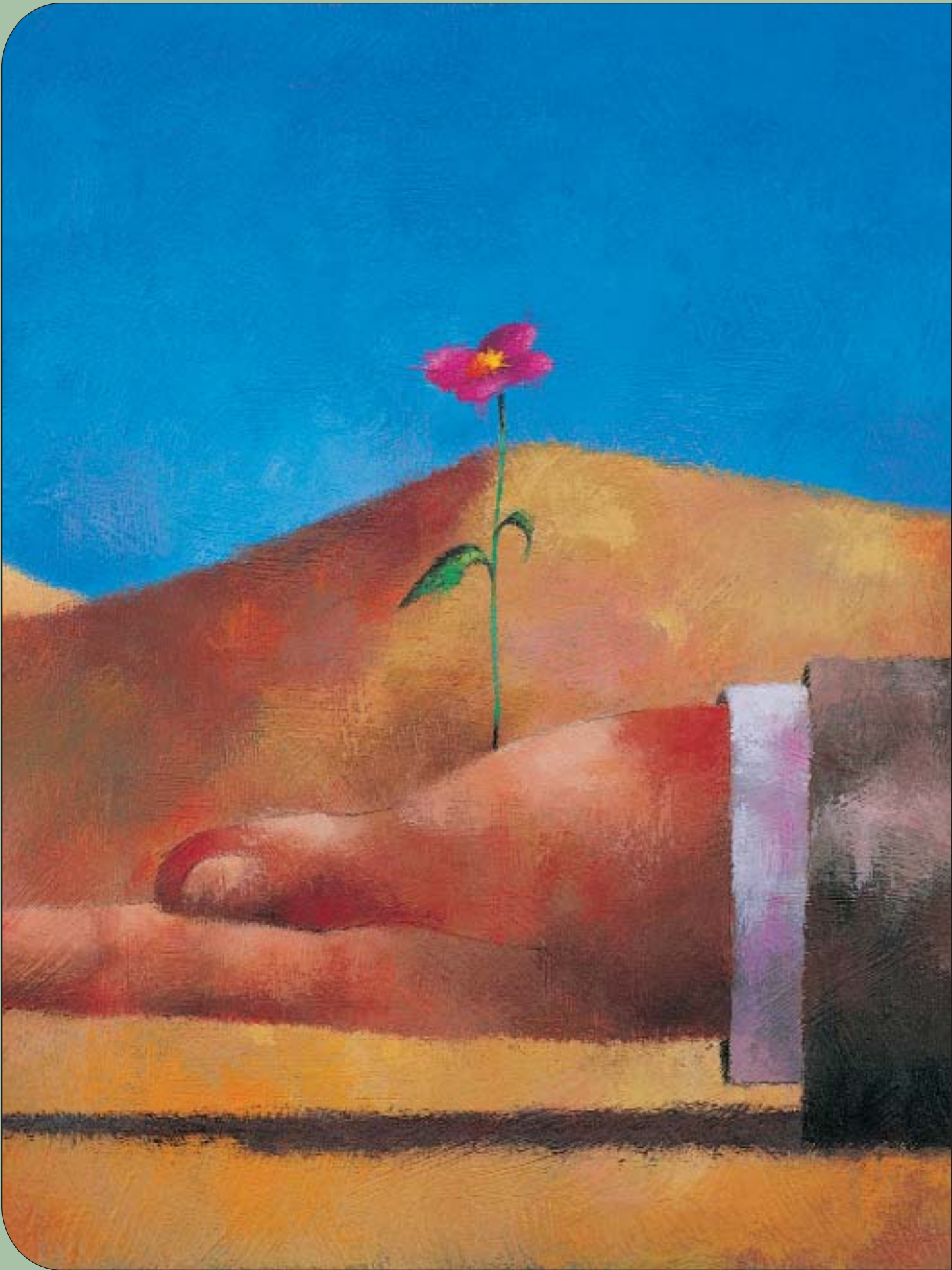
National Venture Capital Association (NVCA)

The National Venture Capital Association (NVCA) represents more than 450 venture capital and private equity organizations. NVCA's mission is to foster the understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, facilitate networking opportunities and to provide research data and professional development for its members.

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Vigneron Capital

Applying Winemaking Principles to Venture as a Means of Thriving in the Difficult 2009 Growing Season

BY

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JOSH KOPELMAN,
AND PAX MAHLE

Ed Zimmerman founded and runs the Tech Group at Lowenstein Sandler PC, a leading venture law practice (www.lowenstein.com), teaches VC and angel investing to MBA candidates at Columbia Business School, and angel invests through www.grapearborvc.com, which he co-founded. For purposes of wine “street cred,” Ed was inducted into (but can’t necessarily pronounce) the Confrerie des Chevaliers du Tastevin at the Clos de Vougeot in Burgundy.

Josh Kopelman is a recovering entrepreneur and currently runs First Round Capital, a seed-stage venture capital firm with offices in San Francisco and Philadelphia. With two young kids, his whine-to-wine ratio is not where it should be. He enjoys a nice glass of wine whenever he can and, when he can’t, he writes the popular blog www.redeye.vc

Pax Mahle is the “vigneron” (wine and vine guy) for Wind Gap Wines, a Sonoma, CA-based boutique winery — <http://www.windgapwines.com>. He previously founded and was the wine and vine guy at Pax Wine Cellars, also in Sonoma, CA. His Wind Gap Wines projects are wines of true passion from some heralded and some very under-appreciated regions and varietals throughout California.

A group of venture capitalists (VCs), sharing some terrific wines over a dinner at which the discussion turns to venture. Two of these authors confess to having spent, oh, at least hundreds of hours engaged in this important pastime. At one such recent dinner, guests hailing from venture “hot spots” Boston, New York and California reflected on the fact that good winemakers can coax greatness from grapes that have experienced severe stress.¹ Does stress exogenously imposed on start-ups enable good VCs to more effectively coax greatness out of their portfolio? We believe that, under the current *economic crisis* (apparently the phrase you use when you haven’t yet decided whether you’re in a recession or a depression), good VCs can apply a “Vigneron Capital” approach to help early stage companies achieve greatness in the current vintage. Conditions of exceptional stress can produce tremendously wonderful returns as well as wines, if you know how to optimize.

The French word “vigneron” has no single equivalent in English. In rough translation, it refers to the person who not only raises the vines and wine grapes in the vineyard but also makes the wine. Conversely, the English word “winemaker” has no single French equivalent,

¹ If you don’t find this article persuasive, we suggest that you have two or three excellent glasses of wine (the footnotes are dripping with recommendations or, pick your own — if your selections rhyme with “Chateau Fargaux” or can be abbreviated as “DRC,” you’re on the right path) and *then* re-read this, to reproduce as accurately as possible the conditions under which this article was conceived.

probably because the French firmly believe that great wine is “made in the vineyard,” not in the winery. The French believe that tending the vines and grapes as they mature is an essential component of making great wine. We believe that the most important thing a winemaker can put in the vineyard is his footprints. With that prelude, we offer a perspective on *Vigneron Capital* for today: how the tenets of making great wine apply to the current vintage of venture capital. The authors are an actual American vigneron (his boots are caked with Sonoma soil), an early stage venture capitalist and former entrepreneur (if cortices could have calluses from overwork and stress, his would), and a venture lawyer/early stage angel investor/wine geek (his eyes are red-rimmed from lack of sleep, setting off his purple-stained teeth).

Eight Core Tenets of Vigneron Capital

In a Heat Wave, Be Bordeaux

“The 2003 vintage in Europe has been characterized as bordering on the bizarre. The weather was extreme, particularly in France, where a long, deadly August heat wave challenged winemakers.”² The historic heat wave that year claimed nearly 15,000 lives in France.³ This was stress to the system of epic proportions. The extreme weather yielded many disastrous wines in Burgundy, but in some spots of Bordeaux, vignerons were able to achieve greatness.⁴ The Bordelaise found greatness in 2003 because they typically struggle with a paucity of heat and a surfeit of moisture. A deadly heat wave can cure those problems and permit the heat-loving Cabernet vines to thrive as they do in the drier and warmer climate of Napa. Conversely, the very fickle and delicate pinot noir grape, *the* red wine in Burgundy, cooks and dehydrates in the face of that much heat. This leads us to the first of our Vigneron Capitalist principles for making great wine and VC-backed companies in the current challenging vintage: if you know the weather conditions in advance, you

² Eric Asimov, “St.-Émillions, Ripe From the Heat of 2003” (1/10/07) New York Times (<http://www.nytimes.com/2007/01/10/dining/reviews/10wine.html>, last visited 1/27/09).

³ (http://en.wikipedia.org/wiki/2003_European_heat_wave#France, last visited 1/27/09).

⁴ Checkout the 2003 Chateau Margaux, for instance – of course, you may want to wait until your next portfolio company exits at 10x, but the wine is a stunner!

need to pick the spot and grapes that will thrive under those conditions, even if the conditions are extreme. Elaboration on that maxim follows.

Select Your Sunny Side

As in France, it all starts in the vineyard. You can’t make great wine unless you choose the right site, or “terroir” as the French say — the combination of soil type, location, elevation, humidity, wind, climate, sun exposure and the many other variables that constitute a “place” for growing wine grapes. So for instance, when the Emperor Charlemagne saw that snow melted first on a certain patch of hillside in Burgundy, he directed his men to plant there because the sun exposure would enable him to optimize the grapes in that sun-kissed spot – now known (according to legend) as Burgundy’s famed Corton Charlemagne. Similarly, our Vigneron Capital approach militates in favor of picking the sectors and stage that you feel will receive optimal sunlight and temperatures; where the soil composition is ideal for planting your capital. We are currently seeking those terroirs which will outperform in a multi-year economic downdraft. Some Vigneron Capitalists are advocating that now is the time to invest in later-stage opportunities. In fact some well known VCs are even deploying capital in public securities. Others (like these authors) believe that early stage investing is the right terroir in this new climate. In times with little liquidity and challenging fundraising environments, we believe it makes sense to seek ways to fund capital efficient companies whose valuations align with exit conditions.

Prestige Can Inflate Valuation – Buy Oakville Vineyards in the 1980s

Bordeaux is the wine of the aristocracy, endorsed by no less an oenophile than Thomas Jefferson and steeped in centuries of legend and magic. It is not, however, the only road to greatness and “value Bordeaux” is as oxymoronic today as “profitable dot.com” was in 1999! Consider instead the possibility that some regions might present phenomenal opportunities because we Vigneron Capitalists, like our portfolio companies, will have first mover advantages ... don’t be the 100th social networking company. For instance, Napa received little

respect until the Paris Tasting in 1976 demonstrated that its wines could best some of France's vinous titans. Even after that affirmation, those who studied the market, did soil testing and bought Napa terroir ten years later, still made a killing. To be more specific, Jean Phillips knew the Napa Valley well (she'd "walked the rows" many times as a realtor selling Napa properties) when she purchased 60 acres for herself in Napa's Oakville in 1986 (ten years after the Paris tasting). She patiently sold off her wine grapes as she took time to assemble a team and ensure that the conditions on her land were right. In 1992, she bottled 500 cases of her own production, which she first marketed several years later for \$50 per bottle. That wine, Screaming Eagle, became the most sought after and expensive wine in America. Having assembled a great team, made a consistently acclaimed product, and built the right brand, the wines were fetching upwards of \$1500 a bottle. At that time, in the Spring of 2006, she 'harvested' the investment for a sum reported to be not less than \$500,000 an acre – even for the unplanted acres!⁵ Similarly, the wine consuming public accorded little value to the glorious Grenache vineyards of Chateauneuf du Pape in the Southern Rhone before several consecutive home run vintages from 1998 through 2001 made clear the value of these ancient plantings. Vigneron Capitalists don't drink prestige, they drink and make quality wines and enjoy finding them in as of yet unheralded regions. Now is the time to discover these regions of our own markets and test the soils. This leads to our next precept.

When Opportunity Knocks, Don't "Louse" It Up: Buy Quinta de Vargellas During Phylloxera

Phylloxera is a pernicious plant lice that almost wiped out the vineyards of Europe in and around the 1870s. During the 1890s, Portugal's great port vineyards were under siege and economic conditions were disastrous. Quinta de Vargellas, one of Portugal's greatest vineyards, was particularly stricken by phylloxera and production was roughly 1/20th of what it should have been. Taylors, arguably the best port maker, saw an opportunity in this

⁵ Widely reported, but see, for instance, "Jean Phillips sells Screaming Eagle" in the Napa Valley Register (3/26/06) http://www.napavalleyregister.com/articles/2006/03/23/features/food_and_wine/iq_3357852.txt, (last visited 2/12/09).

debacle. Taylors bought Quinta de Vargellas knowing that it would take capital and several years to replant the vineyard before it could harvest true rewards. That purchase, made in the mid-1890s has paid off in spades (or port) for them and port-lovers the world over for the subsequent 100 years.⁶ For Vigneron Capitalists who have capital to deploy this vintage, commit to finding extraordinarily undervalued properties (for instance, look at disfavored sectors), and building wines and vineyards for the long haul. NVCA stats tell us that exits are happening 8+ years following initial investment. Go early, plan to stick around, plan to roll up your sleeves and spend time in that vineyard (it's the value add for which we Vigneron Capitalists earn our carry and fees) to make it work. Every economic crisis creates tremendous opportunity to acquire value.

Sweet Things Come in Small (Half) Bottles

While economies of scale are great, for investing in this climate, smaller vineyards are better plays. If we remain in an environment of compressed valuations and the ever-shrinking number of exits above \$200 million dwindles further, the 10x returns we crave will come from early stage investments at appropriate valuations that take time to harvest. In Barsac, Doisy-Daene, for years a sleepy old Chateau, now competes with Thomas Jefferson's beloved Chateau Yquem as among the small handful of vigneron who, in a given harvest, can make the greatest dessert wine in the world. How does Doisy-Daene, which was obscure just 20 years ago, do it? There are numerous reasons, but two of them are: business innovation and technological innovation. From a business perspective, owner Denis Dubourdieu was at the leading edge in the 'business of dessert wines' when, in the 1990 vintage, he decided to make a 'super cuvee' — an ultra-limited top wine called l'Extravagant. The lofty achievement of that cuvee has lifted all of his other wines (and has made at least one of these authors see stars)! Second, Dubourdieu immersed himself in studying the science of making and ageing white wines. He holds several patents on the subject and has become a professor of oenology at University of Bordeaux.

⁶ Quinta de Vargellas is the backbone of Taylor's Vintage Port. Try a bottle of the 1970 or the 2000 to get a taste of what we're talking about! Of course, if your portfolio company IPOs, consider the 1948 instead.

While Yquem makes 9,000 or 10,000 cases in a very good vintage, Doisy Daene will only designate the “l’Extravagant” cuvee in a great vintage and then will only produce a meager 100 to 150 cases of l’Extravagant. Taste the 2003 version of l’Extravagant de Doisy-Daene and Yquem and see if, like Robert Parker, you prefer the upstart’s super cuvee to the legendary Yquem. Robert Parker, the world’s most influential wine critic, accorded the upstart 99 points, while Yquem fetched a still laudable 95 points – no other dessert wine in that region touched Doisy Daene that vintage, according to Parker.⁷ Smaller production allows you to innovate more rapidly and to apply a much higher screen for quality. We believe that large companies in this climate will focus on cost-cutting and be less likely to innovate. As a result, in a few years, they will need to buy smaller companies who have been innovating all the while. The great innovations in winemaking come from the smaller producers where the Vigneron, in his passionate pursuit of excellence, puts his hands in the bin of grapes with great frequency.

Samsonite Is Outta Sight

For each site, what varietal works best — Pinot Noir, Syrah, Riesling? Once you’ve selected varietal, what’s the best rootstock to use? Remember phylloxera ... had the French not ripped out their native rootstock and replanted to American roots just over 100 years ago, there’d be no French wine. And you thought World War II was the first time America saved France? Phylloxera nearly wiped out the vineyards of France until it was discovered that American rootstock was resistant to the nasty vine killer, a discovery which led to widescale replanting. You also need the best clonal material (the branches you graft onto the rootstock) for the plant itself, given the terroir and rootstock.

Vigneron Capitalists must determine which companies best fit within the sector, and which management teams work best within the company. Sure, you want to make a bet on consumer mobile apps. But should you spend more time looking at the enabling technologies,

⁷ An advanced search on the subscription-based website www.erobertparker.com (last run 2/12/09) reveals that Chateau Climens, another delicious sticky wine, came in second for the vintage with 97 points. Try the Climens too – the authors don’t want you consuming our already tiny allocations of l’Extravagant!

rather than the overcrowded and maybe overhyped app space? Now that you’re forcing the entire company to live on a subsistence diet, are you better off with a bunch of youngsters who can live on mac and cheese for 18 months? Or should you tap a seasoned, experienced management team that has prior experience navigating its way through a typhoon, even if you’ll need to stock the office cooler with some aged Cote Rotie rather than an ice cold Red Bull? The authors are currently going long 1999 Cote Rotie, and you should too – that wine has been rocking for years and it will continue to do so (proven winners often win again).

Which brings us to the so-called Samsonite Selections. Years ago, American winemakers made pilgrimages to some of their favorite vineyards in France, hopped the fences, snipped off a few branches, wrapped them in towels, shoved the whole thing into a Samsonite suitcase and took it home. Once on American soil, they grafted these prized branches to try and come that much closer to achieving Domaine Romanee Conti (Burgundy’s best), right here in America, for instance. This is the genetic material that has demonstrated past greatness, and while that doesn’t guarantee future success, it sure does tilt the odds ... as long as it matches the vineyard and terroir.⁸ Vigneron Capitalists strive to position themselves to use the exact branches that have yielded terrific fruit before, assuming they are a “fit” with the new site. This is the reason why the Andreessen Ning branches or the Levchin Slide branches commanded such a high price in the market.

The French largely select vineyards the old fashioned way – they’re born or marry into ownership! In America, we have a much more dynamic situation so we need to constantly keep tabs on vineyards, which ones are available (either because we can buy the land or just some of the fruit), which ones are producing great wines and which have only some of the many characteristics required for greatness. Often Vigneron Capitalists will find the most amazing property but the team has inexplicably planted Chardonnay in soil best suited for Syrah (great sector, wrong idea), or they’ve

⁸ When gathering Samsonite Collections, you want to take branches from different vines in the vineyard so that you capture the biodiversity – the best vineyards have multiple clones, each serving a different function, but together creating harmony. A company with five great CFOs won’t work too well.

planted Syrah, but used the wrong clonal material (great idea, wrong management team). Sure, you can graft over to better clonal material, but that's painful and in a market in which vineyard plantings and clonal material are increasing in supply, why not find a more optimized vineyard. Let's face it, access to proven clonal material won't be a problem in 2009 as many tremendously talented veteran entrepreneurs appear to be hitting the market. We know that if we have repeat success (great scores⁹ from Robert Parker or Cambridge Associates), the owners of the best vineyards will call to ask if we want to vinify a few rows — deal and grape flow will runneth over!

Sacrifice Good Grapes in the Cause of Great Grapes

It's not about making every grape in the vineyard really good, it's about making some of the grapes in the vineyard amazing and then ensuring that those grapes make it into the wine. Grapes compete with one another for nutrients from the vine. Years ago, Vignerons learned that reducing vigor (lowering yield) will enhance the flavor and complexity of the grape and, in turn, the wine. Vigneron Capitalists expend real energy optimizing for this. Vigneron Capitalists do "green harvest," passing through the vineyard cutting perfectly healthy grapes off the vine before they transform from unripe, tart green grapes into a more majestic and sweet purple. Absent the ability to control yields, Vigneron Capitalists would sit on too many boards, squander capital and produce a greater quantity of mediocrity. In the 2009 vintage in particular, pruning fruit before the grapes turn purple will be key as difficult conditions will require us to spend tremendous time in the vineyard. Moreover, the most recent vintages have led to an overabundance, so it's likely that many Vigneron Capitalists already have too much mediocre juice in barrel and won't be able to spend enough time to make all of that unfinished wine into great wine. It may well make sense to sell off (or "bulk out") some of the lesser barrels of maturing

⁹ Though he was surprised to hear this when we told him (and cringed when we said it would appear in this article), in his eight vintages as a winemaker, Pax has vinified 20 wines which Robert Parker has rated 95 points or better. Few winemakers in America can match that degree of critical acclaim. Ratings aren't the be all and end all, but as with good press for portfolio companies ... smoke 'em if you've got 'em -- particularly in a down market, you want to use the positive press you receive. (Advanced search last run on www.erobertparker.com on 2/11/09).

wine to ensure that you can devote sufficient time to optimizing your most promising new grapes and best existing barrels. Vigneron Capitalists do not want to make large quantities of mediocre wine. We're in this to make a reasonable amount of exceptional wine — wine which, when consumed at dinner years later gives great joy and is capable of creating an exceptional memory.¹⁰ This is hard work and Vigneron Capitalists need to spend time walking the vineyard and getting to know our rows so that we know when to drop fruit and when to harvest, not just based on the calendar. Time and capital are both scarce resources, and the most successful VCs allocate them appropriately, even ruthlessly. You also need to be able to rapidly recharacterize and triage: if fermentation is going too quickly, or if the wine just plain starts to smell foul, swift action must be taken — indecision at critical junctures will ensure lousy wine. This is what separates the Vignerons from the winemakers.

Know When to Hold, Know When to Harvest

Each vintage and each vineyard will differ. Some vintages and terroir will be great for Syrah (or enterprise software and semiconductors). In others, you wouldn't want to be caught dead with those varieties or you'll have to "bulk out" the whole crop. By spending the time with the vines, Vigneron Capitalists should, over years of doing this, develop a sense for how to determine when to harvest. Winemakers use a machine to measure brix (sugar levels) and another device to check acidity. But Vigneron Capitalists know not to base harvest decisions solely on these measures — or any purely metric-based determinants. Vigneron Capitalists also place emphasis on checking for physiological ripeness. Anyone can buy and use a brix meter, but physiological ripeness involves looking at the color of the seed, the way in which the grape's pulp releases from the seed and from the skin, the color of the skin, the way the berry pulls off the stem, among other factors. While an ordinary layperson using a text book can roughly assess physiological maturity, a Vigneron Capitalist who has spent time in those vineyard rows will, in much more subtle and accurate ways, be better equipped to intuit

¹⁰ Try Pax's 2001 Walker Short Rows or 2004 Majik Vineyard (he doesn't know we're including these, shhhh!).

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the right time. There's no substitute for experience in these matters and when you grow and make wine, you always want to have the benefit of experience and wisdom on your side, that's part of the value-add. If nobody on your core team has it, you need to go and find it. The difficult vintages of 2001 through 2003 were a test run for the 2009 growing season. You want to have someone around who worked the vineyard in those vintages and learned from the experience.

Harvesting also requires taking real risks. Making wine from rain-soaked grapes is tantamount to pouring Evian into the barrel. Do you take in green grapes because you need to harvest before the impending rains? Vigneron Capitalists must have the courage to take real risks. Of the nine vintages of wine Pax has made in Sonoma, only 2005 saw fruit achieve physiological maturity at alarmingly low sugars. Low sugars lead to low alcohol in the wine, among other things. For years, Pax had loved the elegant, lower alcohol Syrahs of France's Northern Rhone (Cote Rotie, Hermitage and Cornas). In 2005 he faced a dilemma: let the grapes hang longer to reach "California" ripeness, or despite the last five vintages, adopt the view that these particular grapes were never going to attain "California" sugar levels in this vintage? In short, Pax had to decide whether to harvest right away and make a low alcohol wine whose style differed from all prior vintages of Pax's wines or roll the dice and risk over-ripening and destroying the vintage. Pax listened to his gut and harvested at a much lower sugar level than usual because the chemist's instruments were, to him, not as important as his touch and taste of the grapes and his intimate knowledge gained from walking those rows on a very regular basis. Instead of the typical 14% or 15% alcohol, in 2005, some of his wines were 11% or 12% alcohol. Sonoma had experienced a much "riper" harvest in 2004, from the chemist's view, and in fact the 2004 wines just plain tasted better when in barrel than their 2005 counterparts did at the same stage. Interestingly, in bottle, it's no contest – Pax's 2005 Syrahs are, to Pax

and to us, more elegant wines which will have the "stuffing" to continue to achieve greatness for many years to come. While garnering high ratings in a barrel tasting is nice and will sell wine (or raise the valuation of your B round), Vigneron Capitalists are looking to build wines that last and perform well with dinner when properly aged. If we wanted to rush things, we'd run hedge funds and make Beaujolais Nouveau, sold as soon as possible after the grapes are transformed into wine. There's nothing wrong with Beaujolais and it can be quite tasty, it just can't achieve true greatness and longevity – returning massive multiples of cash on cash beats a good IRR that returns 2x.

As John Belushi Said, Our Advice to You Is to Drink Heavily!

Given the weather report for the current vintage, now is a great time to be watching and selecting winning vineyards, particularly in undercover areas, dropping grapes for green harvest, bulking out barrels of last year's wine, and, as always, walking the rows. Josh and Ed intend to continue to work those vines and Pax, well, after an eight year run at Pax Wine Cellars, he's just become the founder/vigneron of Wind Gap Wines, so he'll have plenty of opportunities to apply what he's learned from Josh and Ed. But perhaps the tenets of venture and angel investing they've shared with him are really just the same principles he's been using to make great wines all these years. ☺

*In the vines and drinking the wines,
Pax, Josh and Ed*

