

Part 2 of 32

Venture Capital Economics: How VC Funds Are Structured and How They Think

Fund structure, LP and GP economics, the management fee and carry model, fund lifecycle, portfolio construction logic, and the return math that drives every VC decision

WHAT YOU WILL LEARN AND WHY IT MATTERS

The decisions a venture capital investor makes — which companies to fund, at what valuation, with what terms, and how aggressively to follow on with subsequent rounds — are not arbitrary. They flow from a specific economic architecture that every venture fund operates within: the management fee and carry structure that determines the GP's economic incentives, the fund size and portfolio construction logic that determines how much capital any single company can receive, the fund lifecycle and deployment pace that creates pressure for certain investment decisions at certain times, and the return math that determines what outcomes are actually meaningful for the fund.

The CFO who understands this economic architecture is in a fundamentally different position from the one who does not. When the VC proposes a valuation that seems low, the CFO who understands the fund's ownership percentage requirements can engage analytically with the proposal rather than simply accepting it or reacting emotionally. When the VC declines to lead the next round, the CFO who understands the fund's reserve policy and deployment timeline can assess whether the decision reflects a loss of confidence in the company or simply a fund management constraint. When the VC pushes for an aggressive growth plan that requires capital intensity, the CFO who understands the carry math can see why that plan is in the VC's interest even if it creates financial risk for the company.

This understanding does not mean that the CFO's interests and the VC's interests are opposed — in the best venture relationships they are deeply aligned. But it does mean that the CFO can engage with the investor as an analytically prepared counterpart rather than as a passive participant in decisions whose rationale is not fully understood.

THE VENTURE FUND STRUCTURE

A venture capital fund is a limited partnership — a legal entity in which the general partner (the VC firm) manages the fund and the limited partners (the investors who provide the capital) contribute the money but have no role in investment decisions. This legal structure creates specific economic relationships that the CFO must understand.

THE LIMITED PARTNERS: The limited partners of a venture fund are the institutions and individuals who provide the capital that the fund invests. Typical VC fund LPs include university endowments, state pension funds, insurance companies, family offices, sovereign wealth funds, and fund-of-funds (investment vehicles that pool capital from multiple LPs to invest across a portfolio of VC funds). LPs commit capital to the fund for a specified period — typically ten years, with possible extensions — and the GP calls this capital as needed to fund investments and expenses.

THE GENERAL PARTNER: The general partner is the VC firm — the organization of partners and investment professionals who source, evaluate, and manage the fund's investments. The GP typically commits one percent to two percent of the fund's total capital alongside the LPs, aligning the GP's financial interests with the fund's performance. The GP is responsible for all investment decisions, all portfolio management activities, and all fund administration, including the preparation of financial reporting

to the LPs.

THE FUND LIFECYCLE: A venture fund's lifecycle has three primary phases. The investment period — typically the first three to five years of the fund — is when the GP deploys the committed capital into new investments. The monitoring period — roughly years four through seven — is when the GP actively manages the portfolio, supporting companies through follow-on investments, operational guidance, and exit preparation. The harvest period — typically years seven through ten — is when the fund realizes returns through exits (IPOs, M&A, or secondary sales) and distributes proceeds to the LPs. Understanding where a fund is in its lifecycle tells the CFO a great deal about what the investor needs: a fund in its investment period is looking to deploy capital and may be more flexible on terms; a fund in its harvest period needs exits and may be more pressured about timing.

THE MANAGEMENT FEE AND CARRY MODEL

The economic engine of a venture capital fund is the management fee and carry model — the two-part compensation structure that determines how the GP makes money and therefore what financial outcomes the GP is genuinely motivated to achieve.

THE MANAGEMENT FEE: The management fee is an annual payment from the fund to the GP, typically equal to two percent of the fund's committed capital during the investment period and two percent of the invested capital (or net asset value) during the monitoring period. For a two-hundred-million-dollar fund, the management fee during the investment period is four million dollars per year — a sum that is intended to cover the GP's operating expenses (salaries, rent, travel, and legal fees) but that does not, in most years, generate significant profit for the GP.

The management fee creates a specific economic dynamic: the GP must invest the fund's capital to justify the ongoing management fee to its LPs, and a GP that fails to deploy capital — that holds cash rather than making investments — will face pressure from its LPs to accelerate deployment. This deployment pressure affects the valuation environment: when VC funds have large amounts of undeployed capital (dry powder), competition for deals increases and valuations rise; when dry powder is low, competition decreases and valuations moderate.

THE CARRIED INTEREST: The carried interest — or carry — is the GP's share of the fund's profits above the hurdle rate. The standard carry structure is twenty percent: after the LPs have received back their committed capital plus a preferred return of typically eight percent per year (the hurdle), the GP receives twenty percent of all additional profits. For a two-hundred-million-dollar fund that returns six hundred million dollars to the LPs, the GP's carry would be approximately eighty million dollars (twenty percent of the four-hundred-million-dollar profit above the return of capital).

The carry is the primary economic motivation for the GP's investment decisions. A deal that generates a ten-times return on a ten-million-dollar investment contributes ninety million dollars to the fund's return above basis, generating approximately eighteen million dollars of carry for the GP. A deal that returns only one times the invested capital contributes nothing to carry. This asymmetry creates a specific preference

structure in VC investing: GPs are strongly motivated to make investments with the potential for extraordinary returns (ten times or more), even if those investments have a high probability of failure, because the expected carry contribution from a potential ten-times winner is much higher than the expected carry contribution from a likely-but-modest-return investment.

THE IMPLICATION FOR COMPANY FINANCIAL MANAGEMENT: The carry math has direct implications for how the VC investor views the company's financial decisions. An investment that is growing at twenty percent per year and generating positive EBITDA is a financially healthy company — but from the VC's carry perspective, it may be a mediocre investment if the exit multiple will be five to seven times the entry valuation rather than the ten to fifteen times required for a meaningful carry contribution. The VC who holds this view will push for higher growth investment that sacrifices near-term profitability in pursuit of the revenue scale that justifies a higher exit multiple. The CFO who understands the carry math can engage analytically with this push — modeling the financial trade-off between growth investment and profitability, assessing the valuation impact of different growth trajectories, and contributing to the board's informed decision about the appropriate balance.

PORTFOLIO CONSTRUCTION AND THE POWER LAW

Venture capital portfolio construction is driven by the power law expectation — the empirical observation that venture capital returns are not normally distributed but follow a power law: a small number of investments generate the overwhelming majority of the returns, while most investments return less than the invested capital.

THE PORTFOLIO CONSTRUCTION MATH: A standard venture fund might make twenty to thirty initial investments, expecting that roughly one-third will fail (returning zero), one-third will return between one and two times the invested capital (modest outcomes that cover losses but contribute little to fund returns), and roughly one-third will return three times or more with a small number returning ten times or more. The fund's total return depends almost entirely on the performance of the top two or three investments — the portfolio companies that become the fund-defining winners.

This portfolio construction math has specific implications for how much capital a VC fund can commit to any single company. If a fund makes twenty investments of five million dollars each from a one-hundred-million-dollar fund, it must hold reserves to follow on with additional capital in the companies that are performing best — the potential ten-times winners that deserve more capital. Typically, a VC fund will allocate roughly half its capital to initial investments and half to follow-on investments in the top performers. This reserve management discipline means that the amount of capital available to any specific company depends not just on the company's performance but on the performance of the rest of the portfolio — if other portfolio companies are consuming reserves rapidly, less capital is available for follow-on investments in the company the CFO is managing.

THE OWNERSHIP PERCENTAGE REQUIREMENT: The portfolio construction math also drives the VC's ownership percentage requirement. A fund that needs ten-times returns to generate meaningful carry must ensure that its ownership percentage in the potential ten-times winners is large enough for the return

to be meaningful to the fund. If the fund invested five million dollars for ten percent of a company that exits at five hundred million dollars, the fund's return is fifty million dollars — a ten-times return on the individual investment, but only fifty million dollars of the fund's overall return. For a two-hundred-million-dollar fund, that contribution is meaningful but not fund-defining. The VC's ownership percentage requirement — typically fifteen percent to twenty-five percent at the initial investment — is driven by this return magnitude analysis.

RETURN MATH AND EXIT EXPECTATIONS

The most direct application of the VC economic framework for the CFO is the return math — the calculation that connects the company's current valuation, the VC's investment amount, the VC's ownership percentage, and the exit valuation required for the investment to generate the return the fund needs.

THE RETURN MULTIPLE TARGET: A VC fund targeting a three-times net return to LPs needs its portfolio to generate approximately five times gross returns (accounting for management fees, losses, and the J-curve of early fund performance before exits are realized). For a fund that made a ten-million-dollar investment at a one-hundred-million-dollar post-money valuation (a ten percent ownership stake), the exit valuation required for a ten-times return on that investment is one billion dollars. If the VC believes the company's realistic exit range is three hundred million to five hundred million dollars, the investment will return three to five times — a meaningful contribution to fund returns but below the ten-times threshold that makes an investment fund-defining.

THE DILUTION IMPACT ON RETURNS: As a company raises subsequent rounds of financing, the VC's ownership percentage is diluted — additional shares are issued to new investors, reducing the percentage of the company that the original investor owns. The VC manages this dilution through pro-rata rights (the right to invest in subsequent rounds at the same terms as new investors in order to maintain the ownership percentage) and through anti-dilution provisions (provisions that protect the VC's effective ownership percentage if subsequent rounds are priced at a lower valuation than the VC's entry price).

The CFO must model the dilution impact of each subsequent financing round on every existing investor's ownership percentage, because this analysis is fundamental to the board's informed decision about the terms of each new financing — including the trade-off between accepting a lower pre-money valuation (which increases dilution) and accepting more onerous terms (which may be less dilutive but more restrictive on the company's financial flexibility).

ACTIONS TO TAKE BEFORE PART THREE

Build the fund lifecycle model for each venture investor in the company's capital structure. For each fund, identify the fund's vintage year (the year in which the fund was formed), the fund's approximate size, and the fund's current stage in its lifecycle (investment period, monitoring period, or harvest period). This analysis tells you whether the investor is in a position to lead additional rounds, is primarily focused on managing existing investments, or is under pressure to realize exits within a specified timeline.

Build the return multiple model for each VC investor: the investment amount, the post-money valuation at the time of investment (which implies the ownership percentage), the current estimated enterprise value, and the return multiple that the current enterprise value implies for each investor. This model reveals each investor's current return position and the exit valuation required for each investor to achieve their target return — information that is essential for understanding each investor's perspective on exit timing, growth investment, and valuation in subsequent financing rounds.

CLOSING PERSPECTIVE

The venture capital economic architecture — the fund structure, the management fee and carry model, the portfolio construction logic, and the return math — is the analytical foundation for understanding every significant decision that a VC investor makes. The CFO who internalizes this architecture is equipped to engage with venture investors as an analytically prepared counterpart: understanding what the investor needs, why they need it, and how the company's financial decisions contribute to or detract from the financial outcome the investor is working to produce.

COMING NEXT IN THE SERIES

Part 3 — The Funding Round: Term Sheets, Valuation, and the CFO's Role

Part Three covers the mechanics of a venture funding round from the CFO's perspective — pre-money and post-money valuation, the term sheet provisions that matter most financially (liquidation preferences, anti-dilution, pro-rata rights), the due diligence the VC will conduct, and the CFO's role in data room preparation and financial due diligence management.