



# 7 Reasons Why Great LPs Invested in Our First-time Venture Fund

*\* and a few things we would do differently next time*

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By William B. Rosenzweig, Managing Director, Physic Ventures LLC

My partners and I have recently completed an arduous and exhilarating eighteen month journey organizing our first-time venture capital fund, **Physic Ventures**, created with the purpose of *investing in keeping people healthy*<sup>1</sup> in the consumer-driven health and sustainable living sectors. Launching a new venture fund, with a new team, in an emerging sector is considered an extremely ambitious and risky undertaking. According to John Taylor, Vice President of Research at the National Venture Capital Association (NVCA), there have been 13 first time funds organized so far in 2008, a number substantially below normal. (The annual average for new funds is about 40 per year.) According to John, “raising money for a first time fund in this environment would be extremely difficult right now”. I had underestimated the level of congratulatory amazement and incredulity that was expressed when we publicly announced the final close earlier this month.

Our goal was to raise \$150M from highly regarded institutional investors who shared our views of the rapidly evolving healthcare and green-tech investment sectors and who could add value to our efforts. We aimed to attract a balance of institutional investors---pension funds, endowments and foundations---and corporate investors. During the process, our team learned, grew and evolved substantively. I have endeavored to capture our insights and provide a rationale for why we were victorious---exceeding our expectations for the quality and diversity of the limited partner syndicate and the amount of capital raised. Here are **seven** facets of a complex architecture that contributed to our success at founding and raising a first-time venture capital investment fund.

## 1. **Solid, value-added anchor Investor**

Physic Ventures was formed as a collaborative partnership between Unilever, one of the world’s leading foods and personal care companies, and our general partner (GP) management team. Unilever’s corporate ventures group had a pre-existing relationship with each of our two managing directors in two separate prior fund investments. It was the original insight of the director of Unilever Corporate Venturing to suggest that we team up to take our respective organizations to scale and pursue an emerging investment sector that focuses on the convergence of life science, materials science and consumer products. From our earliest conversations there was an open, honest and trusting dialog established and a consistent and conscientious energy applied toward constructing a complicated partnership. (This characteristic of forthrightness and transparency from a prospective LP was uncommon in the general LP world in our experience, but was shared by all the investors who ultimately joined our syndicate.)

It was the mutual intent of Unilever and the GP to create an independent, financially-driven fund with an integral partnership that would deliver reciprocal strategic benefits and advantages: For Unilever, in addition

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<sup>1</sup> See. [www.physicventures.com](http://www.physicventures.com) for details about the fund’s scope, strategy and leadership team.



to expecting to generate top-quartile venture returns on its capital, it gained access to a strategic window of insights into business sectors that were highly relevant to its future strategy and competitive position. For the Physic team, it gained considerable market and technological expertise by being able to access the global marketing and R+D organization at Unilever (with its 2500 PhD's). In addition, Unilever provided a full-time secondee to the Physic team for the life of the fund to ensure a collaborative flow of communication and activity between the organizations.

The terms and structure of the partnership are worth noting. The limited partnership agreement was constructed to conform to standard market practices with respect to management fees, carried interest percentages and fund governance. Unilever, as the substantive founding sponsor and contributor of about 50% of the total fund capital, did not ask for any preferential rights with respect to access to the portfolio companies, nor did it seek to participate in or influence the investment decisions of the general partner. It relegated its governance role in the fund to a seat on the limited partnership advisory committee (LPAC) in a manner that equalized its influence with other major investors. The key area of agreement was to set up a tightly defined scope for the fund that was compelling to both the GP and anchor LP. This ensured that the fund's investment activities would be relevant to the anchor LP, while empowering the GP to deliver the greatest financial returns without compromise or conflict. This progressive approach and structure set the stage to make the fund interesting and accessible to additional independent institutional investors.

## **2. Niche focus with a compelling, differentiated strategy**

The effort benefited from a clearly differentiated investment strategy with a focus on a promising new niche where the management team had credible expertise and where there were comparable transactions demonstrating that venture capital sized returns were possible. We defined Physic's focus as consumer-driven health and sustainable living---*where life science meets lifestyle*. Physic invests in three types of businesses: enabling technologies, branded products and services and innovative distribution channels. We have been active, hands-on investors, focused on partnering with entrepreneurs to build leading companies. During the past several years, our team members had independently made more than a dozen investments that were representative of the new fund's scope and strategy and carefully delineated how we thought these would evolve and mature over time. We set the new fund's target size at \$150 million, modest by current market standards, (and substantially larger than the prior funds we had managed), yet credibly manageable by the team we had formed. We focused on our predilection for early-stage investments, our prior successes with venture origination and an opportunistic eye for later stage investments that could possibly yield earlier returns. One of the first questions posed by virtually all prospective investors was "tell us about your prior exits". We had none: Our most recent investments, which bore the closest resemblance to Physic's strategy, had not yet come to fruition.

We boldly (yet with ample humility) declared to prospective investors that we were intent on becoming the leading firm in this new sector. One of the most persistent challenges we faced was getting LP's to appreciate that our investment strategy and focus lay at the intersection (and convergence) of several traditional investment sectors that we saw being reshaped by dramatic shifts in consumer values and demographics and rapid changes in the global healthcare economy. Institutional investors traditionally



characterize venture funds in set silos such as “biotech”, “healthcare”, “IT”, “consumer” or “cleantech”. Physic Ventures’ approach is to invest in technology-enabled, consumer-facing companies that help people and the environment stay healthy. To this end, we are all and none of the above. Adding to the confusion in the marketplace was the fact that several other teams had recently launched efforts aimed at capitalizing on a related consumer demographic. There were several firms investing in “health and wellness”, but without a focus on technology. We evolved our communication over the course of the fundraising to clearly articulate the strategy, scope and essential economic and demographic drivers of our opportunity, and ultimately designed a literal “map” of our new territory to orient future partners.

During the fundraising period, we heard some LPs complain of “manager proliferation”, meaning that they now had too many fund relationships in their portfolios and were hesitant to take on new relationships (and were intent on paring back). We also confronted shrinking venture allocations as a result of the widespread economic downturn. One alternative asset manager for a prominent East Coast University told us that his allocation was 30% smaller than it was six months earlier, due to the contracting value of the endowment’s portfolio.

Physic’s differentiated strategy enabled us to stand out from other new funds entering mature sectors. To bolster investor confidence in the new sector’s potential to generate substantial returns we showcased recent transactions that were indicative of the types of investments we were targeting. There were enough recent comparables in the market to illustrate emerging trends, but not so many as to show that we were late or a follower in the sector.

### **3. Experienced, values-led team**

With respect to assessing our team, prospective investors were most interested in understanding our track records, sources of proprietary deal flow and our governance structure. A much smaller number of serious investors were as interested in the softer dynamics of what would sustain our team for the long term.

Our team’s partnership fundamentally came together around shared purpose, vision and values<sup>2</sup>. In the first substantive conversation my partners and I had we talked about what motivated us to make a difference in the world. In our early discussions we didn’t talk about making money (although we would be hard pressed to admit this in fundraising meetings.) The design of our team and its capabilities followed principles I had learned and employed as an entrepreneurial leader in fast growth ventures. This involved establishing ourselves as a learning organization, with a flat, team-based culture and an incentive compensation structure (carried interest) that includes everyone. As such, our partnership resembles and functions more like a small entrepreneurial operating company than traditional, hierarchically-structured groups that look like consulting and banking organizations. We spent considerable time and care articulating and documenting our purpose and values statements as groundwork on which to build a sustainable partnership. We actively use this “constitution” to guide us in our decision-making and investment practice.

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<sup>2</sup> See [www.physicventures.com/purpose.php](http://www.physicventures.com/purpose.php) for detailed explanation of the vision and values of the organization.



Soon after getting started, we engaged an organizational development coach (whom we had put to work in several of our portfolio companies in the past) to work with our team on a quarterly basis. She brings in tools which help us to learn more about how each of us thinks, makes decisions, and communicates, which has translated into strengthening the trust, speed and cohesion in which we pursue opportunities and make decisions together. We strive to foster a culture where rigorous, challenging discussions are expected and encouraged---while maintaining a process that reaches consensus-based decisions. We strive to “disagree without being disagreeable” while we debate tough investment decisions to allocate our resources.

We assembled the Physic team<sup>3</sup> to be capable of assessing both technology risk and consumer market risk, combining individuals with scientific and marketing backgrounds on a single team. This sounds rational, given our scope, but is actually uncommon, if not rare in the venture capital industry to integrate practice areas. Many firms organize discreet investment teams along traditional sectors (biotech separate from IT). Physic’s strategy focuses on converging sectors, so we integrate science and marketing expertise to ensure that there are complementary skills on each due diligence and investment assignment.

#### **4. Finding a “fit” and building long-term personal relationships with investors**

Physic faced two in-bred, industry-wide biases from prospective LP’s: Being a first-time team in a new, unproven sector. We had to find our way to appropriate and qualified investors and then we had to develop trust and demonstrate our capabilities to instill necessary confidence, all within the limited window of time available for fundraising---about nine months. When we began the fundraising process we were naïve about the actual number of prospective LP’s who might invest in the fund—thinking that it was much larger, on a worldwide basis, than it actually turned out to be. We had been encouraged by several fundraising consultants who found our proposition compelling, and had developed a 300 firm prospect list, culled from referrals and databases that identified the thousands of institutions and intermediaries who manage alternative asset portfolios. We were also encouraged because we were able to secure appointments with many investors either directly or through our contacts who wanted to meet and hear our story. During our fundraising we held first meetings or conversations with about 75 different firms. What we didn’t appreciate was that while there were many managers interested in taking the time to meet with our new team and hear about our sector and strategy, most actually had no intention of investing whatsoever. (To sustain oneself during fundraising requires at least the belief in a remote, outside chance.) Many prospects, as we discovered, actually had unstated policies never to invest in a first time fund because the risks were perceived to be too high. (Others were more forthright and told us that up front, but listened to our presentation, nonetheless, setting the stage for “fund 2”.) Another more technical hurdle was that our target fund size, at \$150M, was too small to accommodate the twenty million dollar minimum investment size many of the larger institutions needed to deploy in a single transaction---and this threshold took them over their policy not to represent more than 10% of the total capital in the fund. (The ideal fund size for our scope and sector in the future should be \$200M, the right balance between a small fund, managed by a tight cohesive team, and the ability to attract a diverse base of institutional LP’s.)

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<sup>3</sup> See [www.physicventures.com/leadership](http://www.physicventures.com/leadership)



We observed that many managers of institutional capital who invest in venture capital funds—endowments, insurance companies, pension funds, family offices, governments—do so in a completely retrospective manner, with a “follow-the-herd” mentality. The conventional wisdom is to invest in teams and sectors that are accomplished and mature, although NVCA statistics demonstrate that the best performance for many funds is achieved in their first or second offerings when new teams are cohesive and highly motivated and funds are smaller. In emerging sectors, company valuations are often attractive because the overall sector is under-represented by competing firms. The industry-wide bias makes it doubly hard for a new team in a new sector. We observed that European investors, in general, were more fixated on getting into “US brand name funds”, where established US managers already had these relationships and were more willing to diversify. However, newer US LP’s, particularly fund of funds, were just as fixated on accessing brand names. There was a perception from institutional managers that they could always access a second time fund and there was no advantage to investing early. It is fair to say that at the time of our fundraising launch Physic’s investment sector—consumer driven health and sustainable living--- represented a niche, rather than commodity offering. Neither our team, nor our sector offered the quantifiable benchmarks that are generally used to qualify an investment decision.

Our positioning was to offer investors the opportunity to diversify their venture portfolios and convince them that our niche was highly promising in terms of future financial returns and that we had a unique and credible approach to capturing those returns. There were not many *directly comparable* funds or teams for LPs to consider in this area and there were very few (if any) investors looking to diversify into a sector or team without a substantive track record.

Several months into our fundraise, after two expensive and exhausting road shows in the US and Europe comprised of these kinds of introductory meetings, we began to focus on getting to know a smaller number of alternative asset managers (AAM)—about 20--- where there might be a fit with their focus and strategy. This subset specialized in identifying and investing in “emerging managers” or had a particular affinity to our sector and strategy. Ironically, we decided not to pursue wealthy individuals or family investment offices—frequent targets for new funds--- because we wanted to create a sense of symmetry across our envisioned LP base balancing the substance of Unilever with financial investors of comparable reputation and capacity.

Key to our success was to focus where we detected sincere interest and a straightforward commitment to communication and transparency about process and timing. In retrospect, we did not appreciate the importance of timing with regard to specific funding windows and cycles. A large number of the fund-of-fund (FoF) investors were engaged in committing funds for a current vehicle while simultaneously raising capital for their next, so we had to find a way into the “tail-end” of an open fund, which was challenging, as most of the slots were committed well in advance; or, in a different scenario, we had to find suitable timing so that Physic’s fund would still be open when the FoF next offering was available. In one situation, Physic became the first commitment in a new fund established by a leading manager that specialized in finding and recommending emerging managers for a large pension fund. In another case, a FOF manager was unable to raise its next vehicle as planned, so the verbal indication they gave us was did not turn into a commitment. In another case, a new FOF manager had demonstrated a strong interest, but did not have the bandwidth



and resources to satisfy its due diligence efforts within our timeframe. Of the eight new investors who joined the Physic syndicate, it took about a year from first meeting to final commitment, and then another ten weeks to complete documentation.

## 5. Ability to execute on the strategy during the fundraising period

A common attribute of all the investors who ultimately committed to the fund was that we had been able to build a solid *relationship* with them, transcending the more common transaction-oriented dynamic inherent in investing. All of the investors in the fund had committed to interacting with us on a regular basis, observing our progress for a minimum of nine-months prior to formalizing a commitment. (The rareness of being treated with deference and candor was humbling and served as an enduring reminder about the importance for our entire team to always treat our relationships with entrepreneurs with directness, transparency and mutual respect.)

We realized how important it was for us to be able to clearly articulate what it was we intended to do at the onset, and then deliver and communicate repetitive, short-term results that were indicative of these longer term goals. We attempted to establish a conversation with prospective investors that was clearly focused on demonstrating how we were executing our strategy during the fundraising period.

We spent a lot of energy making our vision and plan vividly come to life through scenario planning and graphic illustration. We produced a powerful “landscape map” of the converging sectors in which we planned to invest<sup>4</sup>. We also developed a schematic that showed the diversification strategy of our prospective portfolio, illustrating the distribution of venture origination, early-stage and growth stage opportunities in which we intended to invest. We developed and documented our unique sources of prospective investments in these sectors. We were careful to maintain the continuity of this framework, and made a point of updating the schematic with the names of our actual investments as we progressed during the fundraising period. Our prospective investors were able to witness the implementation of our strategy and the development of our portfolio, in a visual, focused and intentional manner.

During the course of the fundraising period, we were able to lead and complete five investments that were precisely representative of our sector and portfolio diversification strategies. We were thorough in communicating how these investments fit our approach and made sure prospective LP’s were aware of how we sourced and led these investments. We also raised our credibility because we were able to attract experienced, top-tier co-investors into the syndicates we formed, thus validating the potential of the investment in the eyes of LP’s. In the absence of a prior fund track record to evaluate, and slim sector performance to use as a proxy, we had to shift prospective investors to focus on the strength of our process, our commitment to success, and the progress of reaching milestones that could be indicative of longer term success.

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<sup>4</sup> See the Physic Ventures Landscape Map [http://www.physicventures.com/images/pdf/Physicmap\\_17x25.pdf](http://www.physicventures.com/images/pdf/Physicmap_17x25.pdf)



## **6. WHOST (We had our stuff together)**

To fortify our presence as an established enterprise, we committed to forming an active advisory board and establishing strong operational capability with a professional office infrastructure. In effect, we hoped that prospective investors would view our systems and processes as more mature and established than a start-up “first-time” fund.

We learned to anticipate the next requests in prospective investors’ due diligence process. This involved having well designed and documented systems for governance and decision making, reporting, financial analysis and controls in place during the organizational period rather than developing them as needed. It also involved building a strong administrative team to support the investment professionals. We hired a part-time CFO with extensive fund-accounting and reporting experience to join the team and set up our back-office systems. Despite the fact that she worked mostly from home (balancing a family of three growing children) we worked hard to integrate her seamlessly into the team’s workflow. We engaged one of the leading law-firms specializing in fund organization as counsel. We hired an administrative manager, who although new to venture capital, had strong financial and organizational skills and was a quick learner. We comprehensively documented our investment team’s decision making process and carefully detailed how differences would be resolved. We created a comprehensive policy handbook that proactively described detailed operating procedures. We established filing, tracking and reporting systems gathered from best practices learned from prior experience, other firms and from resources provided by the NVCA.

We made important due diligence and legal documents available in an online data vault so that we could control confidential access to the information. This system was also helpful because we could monitor access and see how active prospective investors were in reviewing our information. It was interesting to see that while a principal contact at a firm might tell us that they were “very interested and were planning to move forward with diligence”, we could actually observe that they were not interested enough to have someone from their team access the vault. It was a useful reality check point.

Most venture investment partnerships publicly use independent advisors to bolster their capabilities and credibility. We were careful to choose advisors with whom we had longstanding, close relationships who were prepared to be actively engaged in our practice. Prospective LP’s were encouraged to know that our advisors were truly serving as an extension of our team, as opposed to a name on a marquee. Indeed, several of our advisors took an active part in the due diligence process, attending meetings and presentations with our group as a statement of their own personal priority and commitment.

## **7. Commitment to apply learning quickly**

The most important value and skill our team developed was the commitment to learn from every experience. During the fundraising period, we lived in a constant state of revision and refinement—strengthening our oral presentation and clarifying our printed materials after virtually every meeting. We made a point of asking for feedback at the end of each meeting and we provided candid and constructive criticism to one another about the effectiveness of our speech after every presentation. One consultant who we travelled with in Europe commented that he had never seen two GP’s give each other feedback in such a



direct, open and honest manner, free of blame or defensiveness. (He had recounted several experiences where partners had burst into heated arguments and even blows following a poor meeting, blaming each other for the performance.) This candor and trust was particularly important in high-pressure situations where travelling distances were great, sleep was illusive and the need to make a compelling impression on demand was strong. We made sure to do our homework prior to our presentations about the people who we would be meeting, learning about their investment histories, preferences and strategies where discernable.

We also were disciplined about bringing our learning back from the road to the broader team at home and involved everyone in a process of distilling what seemed to be working and what was not. During the process, we also solicited input from coaches and mentors—people who had been where we planned to go.

We were persistent in making our learning visible to ourselves and our prospects. At the start of organizing the fund we produced a written business plan we called a “playbook” which clearly stated our strategies, priorities and tactics. This living document helped us focus and coordinate the team’s efforts throughout the process. (We continue to use it as a fundamental tool in our practice.) We found it helpful to share the playbook with prospective LP’s as a means of illustrating our internal strategy and discipline for execution. We were surprised to learn that very few venture partnerships produced or used their own written business plans.

**8. \*And there were a few things we would do differently:**

- Use of agents. We would have had lower expectations for the role of fundraising agents and consultants. We spent precious time and money unnecessarily with people who in the end added very little value. We didn’t know what we did not know at the onset of the fundraise—and we were easily seduced by the enthusiasm of people who offered to take us to the promised land.
- We would have spent less time prospecting in Europe. Because of our relationship with Anglo-Dutch Unilever and their significant presence in Europe, combined with a cultural ethos that resonates with our focus, we thought that Europe would be a fruitful fundraising landscape. We also thought that the weak dollar would be attractive to Euro-rich investors, but to the contrary, there was ample fear at the time that the dollar could go much lower in value.
- Do more due diligence on prospective LPs and their decision-making process. Had we the luxury of time and hindsight, we would have asked LP’s for references to fund groups with whom they had invested so that we could gain visibility into the experiences that other fund managers had raising capital. This might have given us a preview in some cases into negotiating positions around terms, their due diligence process, internal decision making idiosyncrasies, and the amount of time it takes to get to “yes” with a check in the bank.



## **About the Author**

William Rosenzweig is co-founder and managing director of Physic Ventures, a venture capital firm based in San Francisco that invests in keeping people healthy. Will co-founded and served as CEO of The Republic of Tea and was co-author of the best-selling book “The Republic of Tea: How an Idea Becomes a Business” (Doubleday 1994). He has held senior leadership positions at Nakamichi, Odwalla and Brand New Brands and has been involved in starting, growing and financing more than two dozen companies. In 1999, he was appointed a Teaching Fellow at the Haas School of Business at UC Berkeley where he originated and taught the MBA course in Social Entrepreneurship for eight years.

This white paper is dedicated to Nick Allen.



## Appendix: **Physic Ventures Closes First Fund Focused on Consumer-Driven Health and Sustainable Living Sectors**

*Venture firm invests at the convergence of life science and lifestyle*

**San Francisco, CA – July 15, 2008** — Physic Ventures ([www.physicventures.com](http://www.physicventures.com)) today announced the closing of Physic Ventures, LP, a \$159 million venture capital fund that invests in science-based, consumer-directed health and sustainable living companies. Physic Ventures “invests in keeping people healthy” and provides capital and expertise to early-stage companies that develop enabling technologies, branded products and innovative distribution channels.

Physic Ventures has made five investments since its first close in April 2007, including Pharmaca Integrative Pharmacy Inc. ([www.Pharmaca.com](http://www.Pharmaca.com)), Espresso Fitness ([www.Expresso.com](http://www.Expresso.com)), Elixir Pharmaceuticals ([www.elixirpharm.com](http://www.elixirpharm.com)), Dreamerz Foods ([www.dreamerz.com](http://www.dreamerz.com)), and Novomer ([www.Novomer.com](http://www.Novomer.com)). Each company reflects the firm’s strategy to invest in technology-driven businesses that enable prevention, prediction, performance, and personalization of personal and planetary health solutions in the consumer market.

"The substantial support we received from high caliber limited partners, both institutional and strategic, is a vote of confidence for our strategy to grow businesses that capitalize on major shifts in the healthcare environment," said William Rosenzweig, Managing Director, Physic Ventures. "We were gratified to exceed our fundraising target and attract a diverse group of experienced investors to our partnership."

Dion Madsen, Managing Director, said "There are pressing challenges in today’s health and sustainability climate that require scientific discovery and entrepreneurial innovation and an ability to bring new technologies to an increasingly consumer-centric market. We believe this presents opportunities and a wave of emerging, burgeoning markets for the development of technologies, products and services that address these issues and, therefore, can result in substantial returns for our investors."

Physic Venture’s six-person investment team brings together a unique blend of investment and company building expertise in life science, materials science, healthcare and consumer marketing. The firm plans to deploy between \$7-12M per company and will develop a portfolio of 14-16 companies with this fund.

### **About Physic Ventures**

Physic Ventures ([www.physicventures.com](http://www.physicventures.com)), is a venture capital firm that provides capital and support to entrepreneurs focused on building exceptional science-based, consumer-directed health and sustainable living companies. The firm’s strategy is to capitalize on major economic, social and political trends shaping the landscape of personal and planetary health, including the rapid migration toward a consumer-driven, prevention-oriented "self-care" paradigm. Physic Ventures is based in San Francisco, CA.