# Understanding Venture Capital Economics: A Simple Guide for DoD Leaders

### Distinguishing VC Funds from VC-Backed Companies

**Purpose:**
This short white paper explains, in plain language, the critical difference between **venture capital firms** and **VC-backed companies**—a distinction that is often misunderstood inside the Department of Defense. It is designed as a simple study guide and a shareable reference for senior acquisition leaders, including PEOs, CPEs, and program managers.

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## 1. Two Different Entities, Two Different Economics

Although they're related, a **VC firm** and a **VC-backed company** have completely different economic models. Understanding the difference is essential when thinking about DoD incentives, profitability, margins, and industrial participation.

## A. Venture Capital Firm (the Fund)

A VC firm raises a pool of money (a **fund**) from limited partners (LPs) such as pension funds, endowments, wealthy individuals, and strategic investors. The VC firm is responsible for:

- Deploying the capital into early-stage companies (Seed, Series A, Series B)
- Helping those companies grow
- Achieving **large exits** that return significant value to LPs

### How a VC Fund Makes Money

A VC fund earns returns **only when portfolio companies exit**, meaning:

- Acquisition (company is bought)
- Initial Public Offering (IPO)
- Secondary sale of the fund's equity (rare)

It does *not* make money from:

- Revenue sharing
- Profit sharing
- Dividends
- Routine operational cash flow

### Why VC Funds Target ~30% IRR

A typical VC portfolio contains **20–30 companies**. The reality is:

- Many will fail outright
- Several will survive but never return meaningful value
- **One or two** must become massive "winners" that return **3–10×** the invested capital

Those one or two companies must be valuable enough to:

- Cover all the failures
- Provide the expected yearly return to LPs
- Justify the risk taken

This portfolio logic is the foundation of the ~30% IRR expectation.

**Key point:**
**A VC fund relies on big exits, not operating profits.** Its financial health depends on the *value* of its portfolio companies, not the *annual performance* of those companies.

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## B. VC-Backed Company (the Startup)

A VC-backed company is the entity receiving investment. It uses the injected capital to:

- Build product
- Grow revenue
- Capture market share
- Increase valuation
- Position itself for an exit (acquisition or IPO)

### How VC-Backed Companies Make Money

A VC-backed company makes money the same way any commercial entity does:

- By selling a product or service
- **At sufficient margin** to scale the business

But the *owners and investors* only realize financial gain when the company:

- Exits through sale or IPO, or
- Negotiates a secondary transaction (rare)

### Why Margins Matter for VC-Backed Companies

**Margins** drive **enterprise value**.
Enterprise value drives **exit value**.
Exit value drives **fund returns**.

If DoD suppresses margins using:

- AUMC-driven affordability targets
- FAR Part 15 cost-reasonableness logic applied to commercial tech
- Suspicion of high efficiency or lean cost structures

…then VC-backed companies cannot achieve the valuation increases needed to justify investment.

**Key point:**
**VC-backed companies need real margin to become valuable enough for a meaningful exit.**

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# Bridge: How Big Exits Depend on DoD's Value System

### A Needed Bridge: How the Big Exit Depends on DoD's Value System

A VC fund survives on one or two **big exits**—the companies that return 3× to 10× their valuation and carry the entire portfolio.

That raises the obvious question: ***What conditions are required for a VC-backed company to become that big exit?***

The answer is straightforward:

- the company must grow revenue,
- scale production,
- maintain meaningful margins, and
- operate in a market where customers pay real prices for real capability.

This is where the DoD becomes a critical customer and, at the same time, where VC-backed companies often collide head-on with the Department's axiological mindset. When DoD suppresses margins, demands cost visibility inconsistent with commercial practice, or sends unpredictable demand signals, it directly undermines the very conditions required for a breakout exit. In short, the VC fund's model and DoD's value system are often misaligned at the exact moment when alignment matters most.

## 2. Why DoD Needs to Understand This Distinction

DoD often collapses the VC firm and the VC-backed company into one idea, but their incentives—and financial realities—are very different.

### What the VC Firm Needs

- Big exits from 1–2 companies out of 20–30
- High valuations driven by strong margins and growth
- Predictable timelines for capital return
- Clear demand signals (P-Go) from DoD

### What the VC-Backed Company Needs

- Pricing models that allow **meaningful margin**
- Contracting pathways that reward efficiency, not penalize it
- Shorter cycles and stable demand
- Opportunity to scale (not just prototype)

### What Happens if DoD Gets This Wrong

- VC funds won't invest in defense-relevant startups
- VC-backed companies won't scale into production
- Promising dual-use technology dies in the "valley of death"
- The primes retain their dominant market share by default
- The innovation base atrophies

**This is an axiological issue.**
It's about what DoD values: control, predictability, low margin—versus growth, adaptability, and speed.

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## 3. Simple Summary

- ✓ **VC funds need big exits to repay LPs.**
- ✓ **VC-backed companies need healthy margins to generate those exits.**
- ✓ **DoD's pricing and contracting system currently prevents both from happening.**

Until DoD aligns its values, incentives, and economics with modern capital markets, private capital will remain at the prototype stage—not the production stage.