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A LOOK AT THE STATE OF VENTURE CAPITAL

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Much has been written about the decline in venture investing regionally and nationally since the bursting of the stock market bubble, most of it apocalyptic and much of it apocryphal. This article provides factual information about the today's venture investing climate, explains how venture capitalists are responding to current circumstances, and details why there is good reason to be bullish on the future of the industry.

2002 INVESTMENT MARKET REVIEW

2002 was among the most disappointing investing years across all markets in recent memory, with public equities slumping on the steady drone of war concerns, terrorism threats, and corporate scandals. The Nasdaq Composite fell 32% during 2002, adding to its 21% loss in 2001. During the past two years, it has fallen 46%. The S&P 500 also turned in another negative year, falling by 23% in 2002. Including a 13% decline in 2001, it has lost 33% over the last two years. Overall, 2002 marked the third consecutive year of losses for the major U.S. stock market indices, a performance last seen in 1939-41.

2002 was also a bleak year for technology initial public offerings with only 15 new offerings totaling $2.1 billion in proceeds. In comparison, 2001 saw 21 technology IPOs totaling $8.9 billion. Last June through November saw no technology IPOs at all – the longest dry spell in many years. The mergers and acquisitions market was equally bearish in 2002, with the technology sector significantly underperforming other sectors. Global technology-related M&A activity fell by 51% in 2002 as compared to a 26% drop for non-technology companies. Total M&A volume was $1.1 trillion in 2002, down 64% from its 2000 peak. The year's 290 deals declined from a count of 336 in 2001, as venture capital funds continued weeding out portfolio companies and buyers took advantage of lower valuations.

The venture capital market turned in a weak 2002, continuing its steady slide since peaking in mid 2000. New commitments of $15 billion were raised last year by 83 funds, down 58% from 2001 when $36 billion was committed to 129 funds. These numbers are reminiscent of 1996, just ahead of the Internet run-up. Notably, 2002 also marked an about-turn among mega-funds. Thirty-five venture firms raised pools of $1 billion or more in 1999-2001. However, last year industry leaders such as Accel Partners, Atlas Ventures, Battery Ventures, Charles River Ventures, and Mohr Davidow Ventures each returned hundreds of millions of dollars to their investors as they sought to appropriately scale their funds to current market demand. Overall, $4 billion in capital commitments have been returned to limited partners. Many mega-funds are looking at much smaller fund sizes for their next funding cycle.

2002 VENTURE INVESTMENT ACTIVITY

Venture capital investment activity also continued its downward trend in 2002, slipping 35% since 2001. According to VentureWire, U.S.-based private companies raised $20.3 billion last year in 2,088 financings, down from a year earlier when startups raised $37.7 billion in 3,226 rounds. Last year's totals were far removed from the boom years of 1999 and 2000, but despite the decline, 2002 remains the fourth-most-active year on record for venture activity.

Biotechnology brought in the most capital for 2002 at $3.2 billion in 262 financing rounds, a small increase over 2001's $3 billion in 219 deals. Enterprise software remained solid, with 322 private financings for the year totaling $2.4 billion, slightly more than half of last year's totals of $4.1 billion in 469 transactions. Wireless investment was also down by about 50% from last year, with 169 deals totaling $1.5 billion compared to 241 deals totaling $3.2 billion.

Silicon Valley was the most active region for venture activity with 409 companies raising $4.8 billion. Boston-area companies completed 212 deals for $2 billion, and New York start-ups posted 133 deals for $1 billion.

Roughly 80% of total invested capital was follow-on financing to keep existing companies afloat. That compares with about a 60% going to follow-on rounds during the venture-investing boom in late 1999 and early 2000. This heavy investment in existing portfolio companies is largely due to the inability of companies to craft either an exit or profits, forcing their investors to continue funding them. 2003-2004 will likely see more venture-backed companies written off as the cleansing process continues.

IPO REALITY SETS IN

In 1999, near the peak of the dot-com frenzy, more than 500 U.S. companies sold stock to the public for the first time – the most ever. Many quickly appreciated in value, with prices doubling or tripling on the first day of trading. Four years later, the picture is sobering: few report a share price higher than at the initial offering. Many are trading at fractions of their offering price; some have been delisted. Those that did best for their investors generally did so by being acquired.

More recently, sanity has returned to the public markets. Huge first-day run-ups are a thing of the past: the average first-day appreciation of IPO stocks has declined from nearly 122% in 2001 to about 6% in 2002. In 1999, profits did not matter: only 10% of venture-backed companies were profitable as they staged their initial offerings. Now, 40% of venture IPOs feature profitable companies, with three to five quarters of earnings growth being the norm. Another sign of the times is the age at which venture-backed companies go public. Over the past two years the average age of a technology IPO has reverted to historical norms of about 7-8 years, after shrinking to as little as four years in 1999.

WHAT AILS THE VENTURE MARKET

Pursuing financing opportunities presented by the seemingly endless bull market, venture funds raised $204 billion in the three years from 1999 to 2001. This is vastly more than the $132 billion raised in the prior three *decades*. About 400 new venture firms started up between 1998 and 2000, bringing the total to about 750. Partner-level headcount more than doubled to 4,000. Mega-funds with individual capital pools exceeding $1 billion became common. As IPO valuations soared, investors became more sensitive to speed of exit than to entry valuation or capital allocation, prematurely rushing over-financed and under-developed companies to IPO. Experienced management teams, customers, and profits all became secondary considerations.

When the stock market boom halted abruptly and then continued to decline over time, venture capitalists found their funds oversized and their investment teams overstaffed for the new reality. Available capital for investment today stands at about $95 billion, or about five years of capacity at 2002's investment pace. Portfolios are stuffed with companies that, while initially built for quick exit, are now facing the prospect of actually making money or dying. Simultaneously, the prospects for winning customers and generating revenue became much tougher as corporate technology spending plummeted.

A SELF-CORRECTING SYSTEM

Of roughly 11,000 venture-backed companies launched in the past ten years, about 5,000 have failed or been merged into other companies. 2003 will continue to see portfolio attrition as investors suspend support for companies that have little prospect of becoming self-sustaining or of generating positive returns. This culling will permit the deserving survivors to fairly vie for market sector control, instead of getting lost in a crowd of look-alike competitors.

Whereas individual companies perish quickly (i.e., once out of cash, they die), individual venture firms can linger for some time due to their long-term structure. However, healthy attrition will occur here, too, as strong company-building venture franchises separate themselves from transaction-oriented market chasers. Five years from now the venture industry will likely look much like it did five years ago, with half the number of partners and firms. Capital pools will scale back to accommodate the market realities of smaller rounds.

THE YEAR AHEAD

While nobody would argue that the past several years have been other than dismal, there is reason to be hopeful for better performance in the future. Despite all the gloom and doom in the press, the U.S. economy appears to be on its way toward recovery. After declining in the first three quarters of 2001, the U.S. economy posted five straight quarters of growth. In that span real GDP grew about 3.2%, close to its 30-year average. The White House is pursuing a new tax stimulus plan and inflation remains tame. The most significant roadblocks to a strong recovery are the ever-present threat of terrorism, growing geopolitical unrest, and concerns over the timing of a rebound in corporate spending.

Corporate technology spending is expected to improve late this year and continue moving up in 2004. Recent Department of Commerce numbers for business investment in information technology show three quarters of growth after quarterly declines dating back to late 2000. Software investment has posted two straight quarters of growth following six consecutive quarters of decline or flatlining. Major drivers include hard dollar cost reductions such as excess inventory reduction and processes outsourcing, and productivity-related benefits from making information technology integration more efficient. However, the magnitude and timing of improvement is unclear: a November 2002 *CIO Magazine* poll forecasts 2003 technology budget increases of 5.1%, while Goldman Sachs anticipates a near-term decline improving by year-end.

The technology M&A environment is also expected to improve modestly in 2003. Stock valuations are retreating to historically defensible levels; the Nasdaq Composite forward's P/E of 39x is still higher than the 25x-30x seen in the early 1990s, but significantly below its peak of over 100x. A large number of sub-critical-mass public and private companies are ripe for consolidation, with many trading below cash value. Technology M&A buyers are now more likely to structure strategic and tactical acquisitions that work from a financial perspective and sellers are beginning to accept the new valuation environment.

During the last 25 years, technology platform shifts (e.g., from closed proprietary systems to open/distributed computing) created significant demand for new information technology products and services. In contrast, today's innovations are not forcing users to open the information technology floodgate. Current budgets are instead focused on short-term, positive ROI projects, and away from longer-term, cutting edge strategic investments. This environment has stunted growth prospects for many companies. At the same time, large diversified technology companies are seeking consolidation opportunities among the smaller players to fill product gaps and move into adjacent markets. This is consistent with a growing trend among technology buyers to favor fewer vendors capable of providing more complete solutions. In software, notable recent examples include Microsoft buying Placeware, IBM buying Rational Software, and Yahoo buying Inktomi. Potential buyers are more confident that business has stabilized, are more focused on preparing for the eventual upturn, and have ample cash and stock to use for acquisitions. At the same time, potential sellers feel increasingly vulnerable as corporations buy more products through the largest high-technology vendors.

VENTURE INVESTING IN DIFFICULT TIMES

High-quality venture funds seek to add value to their portfolio companies by applying operating expertise and strategic relationships to their growth issues. In general, the best-performing funds have partners with technical educations and operating career backgrounds with prior direct P&L responsibility. In essence, these partners have already been where entrepreneurs are trying to go, so portfolio companies can benefit from their collective experience.

In response to the harsher venture climate of the recent past, top tier funds have generally increased their attention to four principle areas:

- **Investment discipline** – initial investment valuations matter more now than they have in many years. Typical new investments have 18 months of working capital and a diverse syndicate that can fully fund the company in the next round if necessary. A typical software company should require no more than $20 million over four financing rounds to reach exit potential.
- **Cash discipline** – portfolio companies are making their balance sheets stretch farther than ever before. Every new hire is intensively scrutinized and cost-justified. Marketing budgets are tightly linked to revenue growth expectations; companies are not simply "brand-building."
- **Management development** – the most important variable over which venture investors have the greatest influence is management team-building. One benefit of the technology recession is the greater availability of more experienced managers across all disciplines; the best investors can help source great management team candidates.
- **Path to liquidity** – Many companies are currently stalled in their progress to generating a successful exit. Venture funds are meeting regularly with every management team to reframe progress, performance, and planning in the context of continually moving the company toward a liquidity event. This constant attention to the long-term goal helps companies avoid blind allies they might otherwise encounter as they face day-to-day management issues.

CONCLUSION

Context and perspective are critical. Compared to the past 40 years, a great deal of money is still going into venture financing. Between 1960 and 1995, the venture industry only invested about $2-3 billion a year. In the late 90's things took off and by 2000 it had reached $100 billion. Even now, with the economy mired in recession, $20 billion was invested in venture companies in 2000. It is reasonable to expect investment returns to revert to the industry norm of two- to three-times invested capital, equating to annual returns of 12% to 20%. For example, from 1980 to 2000 average fund returns were in the mid-teens with top-performing funds delivering returns of 25% or more.

While aggregate deal flow is down by approximately half, top tier venture firms continue to see consistently high-quality investment opportunities at attractive valuations. They continue to invest judiciously, taking advantage of opportunities to engage with early-revenue companies that are priced like pre-product startups.

There is no denying that the past three years have been the most difficult in recent memory, with the venture industry in the midst of a painful but necessary correction:

- "Me-too" companies are fading away, permitting stronger companies to thrive
- Entry and exit valuations are returning to historic norms
- Over-sized funds are scaling back to match market needs
- Inexperienced fund managers are leaving the market
- Cash is king again, with portfolio companies becoming much more disciplined.

Normal cyclical overcorrection is evident. If the markets were excessively ebullient in 2000, they are equally excessively despairing today. Like all capitalist systems, venture capital has two basic components: fear and greed. There was clearly too much greed during the Internet bubble, but now there is too much fear. Overall, there is definite reason to be optimistic that the early stage venture market will stabilize at a healthy level of investment activity and that numerous successful companies will emerge over the next several years.