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Venture Capital Hits a Cash-Call Crunch

Investors May Not Meet Commitments; WaMu, the 'Defaulting Limited Partner'

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Cash-strapped investors are starting to renege on their commitments to venture-capital funds, dealing a blow to an industry that has been the bedrock of Silicon Valley start-ups.

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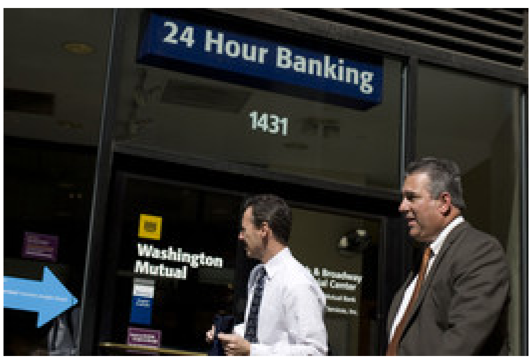

Bloomberg News/Landov

Washington Mutual skipped an October capital call.

From pension funds to rich individuals to once-deep-pocketed financial institutions now in desperate shape, this year's plunging markets have made it much harder for some investors to come up with the money they promised to invest in venture-capital funds.

Such funds invest in private companies over a 10-year time horizon, aiming to profit when the start-ups go public or are sold to other companies. The funds typically collect on investor commitments through periodic "capital calls."

In October, Washington Mutual Inc. skipped a $700,000 capital call from a fund called Financial Technology Ventures Fund III and was listed as a "defaulting limited partner," according to a court filing by the Seattle company last month.

The default came shortly after WaMu filed for bankruptcy protection. In September, federal regulators seized WaMu's banking operations and sold them to J.P. Morgan Chase & Co. Defaulting triggered onerous terms, with the $700,000 now accruing 18% interest.

WaMu faced a deadline of last Saturday to pay up or else forfeit 25% of the capital it previously contributed to the venture-capital fund, run by FTVentures, which has offices in San Francisco and New York. WaMu will lose half that amount if it is still in default in early February. WaMu already had contributed $3.3 million of the $10 million it promised to invest in the fund, according to the bankruptcy-court filing.

In late September, WaMu missed a $30,000 capital call to another fund, Arch Venture Fund V. The company now is trying to sell its venture-fund stakes to other investors. A WaMu spokesman declined to comment, and the outcome of Saturday's deadline isn't clear.

A spokeswoman for Arch Venture Partners, which manages the Arch fund, wouldn't comment. FTVentures didn't return calls seeking comment.

"Lawyers have said everyone should expect at least one default [from investors] in the next year," says Bryan Roberts, a managing general partner at Venrock, a Palo Alto, Calif., venture-capital firm.

Venture-capital funds also suffered defaults during the tech-stock bust earlier this decade. The problem is more severe now because the variety of investors drawn to the riches that can result from stakes in fledgling companies has widened substantially in recent years. Many such investors are reeling as the market swoons.

For example, the largest U.S. public pension fund, the $179.2 billion California Public Employees' Retirement System, or Calpers, has asked private-equity firms to ease off on requests for additional capital it had previously committed to deliver.

Investor defaults can be harsh. Venture-capital-backed start-up companies require cash infusions over time, often from two years to 10 years or longer. Defaults can cause venture capitalists to run out of money to keep start-ups alive.

Some venture capitalists are concerned that the fallout from defaults will be more prolonged this time because there are so few deep pockets around. During the tech bust, Storm Ventures, a venture-capital firm in Menlo Park, Calif., was able to sell the stakes of individual investors who couldn't meet their commitments to institutions, which still had plenty of cash on hand.

Now, though, "there is distress" spread widely among all types of investors, says Sanjay Subhedar, a Storm managing director. While the firm hasn't had any defaults so far, its latest $220 million fund, called Storm Ventures III, will have "to be very careful" about when it issues capital calls to investors, he says.

"In all likelihood, a number of institutional investors will not honor capital calls," predicts Cynthia Steer, a consultant at Rogerscasey. While doing so could break legal agreements, there are few precedents for venture-capital and private-equity funds suing their investors, since they need to maintain long-term relationships with the investment community.

Hans Swildens, a partner at investment firm Industry Ventures, says he recently bought into some venture funds through family-run investment offices and individuals who were unable to make their capital contributions. Since October, Mr. Swildens has invested $30 million in seven transactions to buy out cash-strapped individuals from their venture-fund stakes.

"More defaults are coming," he says.

Battery Ventures is getting calls from a few investors about when the Waltham, Mass., venture-capital firm plans to collect on capital commitments for its $750 million BV VIII fund, says Tom Crotty, a general partner. That is a sign that some investors are watching their cash exposure carefully.

All of the fund's investors met a payment requirement in October, but Battery is communicating with investors more frequently.

A wave of defaults might not be all bad, some experts say, since good times caused the number of venture-capital funds to swell beyond what some in the venture-capital industry thought was healthy. "It's probably long overdue for our industry," Mr. Crotty says.

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