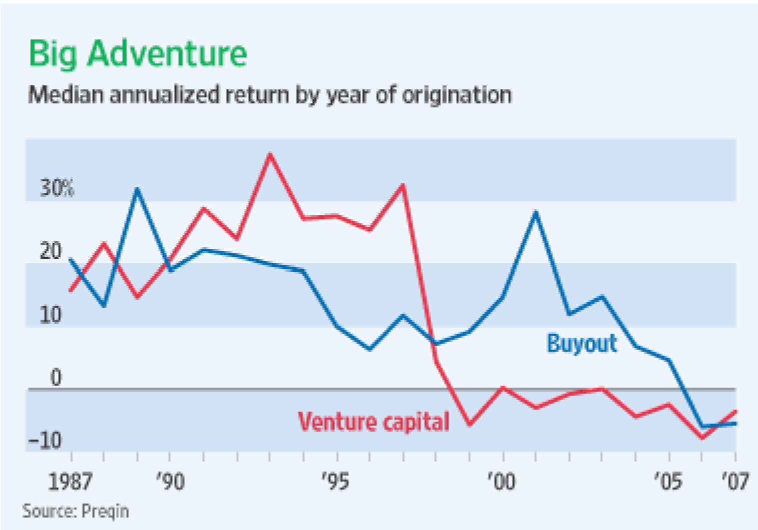
Venture Capital Could Shrivel Away

By JOHN JANNARONE

The only way to break some habits is to hit rock bottom.

Such might be the solution for venture-capital firms, which make equity investments in early-stage growth companies. The industry rode high up to and during the dot-com boom but has suffered a vicious cycle of losses since the bubble burst. U.S. venture-capital funds raised each year from 1999 to 2007 have posted median annualized returns ranging from a 0.3% gain to a 7.7% loss, says research firm Preqin.

Not surprisingly, fund raising has now come to a near halt. Thomson Reuters estimates U.S. venture-capital funds raised just $1.9 billion in the second quarter. By comparison, in the same period of 2000, the peak year, funds raised $33 billion. In 2009, just 170 funds raised new money, compared with 749 in 2000.



It isn't just investors who are walking away. Many venture-capital money managers who joined the game after the '90s have never had a big payday. A decade without performance fees is no incentive to keep digging for deals.

Counterintuitively, this shrinkage could offer a glimmer of hope for venture capitalists, as it should mean less money is chasing deals. Yet hurdles remain. One key to success during the technology boom was the chance to take early-stage companies public. In 2000, some 263 venture-backed companies had initial public offerings, Thomson Reuters says. Even in 2007's bull market, only 86 such firms had IPOs, and just 26 have gone public so far in 2010.

This drought isn't likely to end soon. The market for small-cap stocks has become less liquid as many regional investment banks that specialized in fledgling companies have shuttered. Sarbanes-Oxley reporting requirements have also added several million dollars to the annual cost of being listed, significant for firms on the cusp of profitability.

As a result, venture-backed firms now have one main exit route: selling to strategic buyers. The likes of Cisco Systems and Google have tens of billions of dollars in cash. International Business Machines has recently made a string of software-company acquisitions and remains on the hunt. But such sophisticated buyers are choosy and unlikely to pay IPO-like prices that might boost venture-capital returns.

Of course, the 1980s proved that venture-capital funds can hit home runs without IPO fever. But much of that success was driven by then-emerging technologies linked to PCs and the Internet. Without another big technological shift, innovation opportunities will likely be harder to find.

Venture capital mightn't see another golden age unless a new sector with true growth prospects emerges. Barring that, investors who once allocated fixed amounts to venture capital will become a thing of the past. The sector could shrivel to a handful of funds, losing its status as an asset class alongside private equity.

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