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Venture Funds Sweetening the Terms

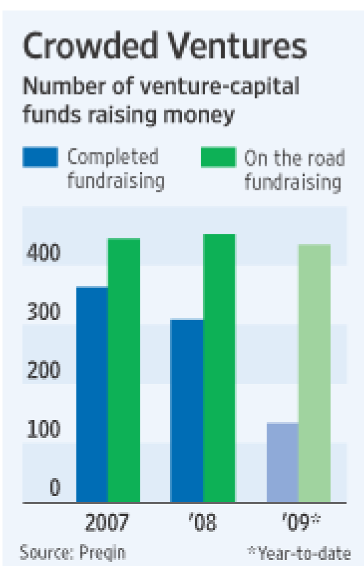
Firms Cut Fees to Lure Investors After Decade of Mediocre Returns; 30% 'Deal Stopper'

By PUI-WING TAM

Venture-capital funds are cutting fees as they scrounge for cash amid a bruising fund-raising environment.

Battery Ventures, Draper Fisher Jurvetson and Opus Capital are among venture-capital firms that have dangled lower costs in front of investors in the past few months. Some are cutting fees outright, while others are building performance-based hurdles into fee structures.

The moves mark the first retreat by the venture-capital industry since the dot-com bust, which forced many firms to cut fees in hopes of luring back investors. Before the latest downturn, fees were steady for several years at venture-capital funds.



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Lower fees will hit venture capitalists in their wallets. Most funds charge a 2% annual management fee based on total assets in the fund. Such fees can add up to $1 million a year for some venture-capital partners, says Jon Holman, a recruiter for the venture-capital industry.
Venture-capital firms get their biggest money from "carried interest," or profits reaped when the companies in which funds invest go public or are sold. Fees on carried interest usually are about 20%, with some funds charging higher carried-interest fees, dubbed "premium fees," of as much as 30%.
The inflow from such fees has been scarce since the financial crisis shrank the pipeline of initial public offerings and sales of venture-capital-backed companies. Now, the fees themselves are heading south.
Opus, based in Menlo Park, Calif., and trying to attract investors to a new $250 million fund, recently cut its carried-interest fee for the fund to 20%. The firm's previous fund charged 25%.
"Better fee terms can certainly make a difference to investors," says Kirk Dizon, a managing director at Hall Capital Partners LLC, which invests in venture-capital funds. These days, carried-interest fees of 30% would be a "deal stopper."
The softening stance follows the venture-capital industry's decade of poor returns. The average return for venture-capital funds fell to 14% for the 10 years ended June 30, down from 34% for the 10 years ended June 30, 2008, largely because the venture returns generated in the first half of 1999 dropped out of the calculation, according to research firm Cambridge Associates LLC.
As a result, many investors are reluctant to put more money into venture capital, especially amid the liquidity crunch from last year's market turmoil. Some venture-capital funds have scaled back their size ambitions or abandoned efforts to drum up cash, particularly with so many rivals competing for capital.
This year, 435 venture-capital funds have hit the road to raise money, compared with 452 for all of 2008 and 445 in 2007, according to research firm Preqin.
Out of that field, just 134 new venture-capital funds had completed their fund raising and closed to investors as of early November, down from the full-year totals of 309 funds in 2008 and 363 in 2007.
The newcomers raised just $20.4 billion in total capital, down 65% from $58.2 billion in all of 2008, according to Preqin.
David Sze, a general partner at Greylock Partners, says the San Mateo, Calif., firm allotted more time than usual to fund raising because of the uncertain market, but ended up raising money for a new $575 million fund in four to six weeks.
One reason investors boosted the fund above its $500 million target: Greylock's management fee is based on a yearly budget that investors must approve, instead of the 2% industry norm. Investors "appreciate" that kind of fee transparency, Mr. Sze says.
According to a person familiar with the matter, Greylock, an investor in social-networking site Facebook Inc., is charging a premium carried-interest fee on the new venture-capital fund.
Battery Ventures is incorporating a performance hurdle into the new $750 million venture-capital fund being raised by the firm. The fund will charge a carried-interest fee of 20%, down from the previous 25%, until it returns three times its capital. After that, the fee will climb to 30%.
Highland Capital Partners LLC, which recently closed on a $400 million fund, also is incorporating a performance-based hurdle into its carried-interest fee, says a person familiar with the matter.
Draper Fisher Jurvetson, which backed hits such as Skype and Hotmail and is raising a fund targeted at $400 million, sent a letter to prospective investors this year that said the firm would charge a premium carried-interest fee only if the fund meets certain performance targets.

Investors would pay a 20% carried-interest fee until the fund returns 2.5 times its committed capital, according to the letter, a copy of which was reviewed by The Wall Street Journal. The fee would increase after that. A spokeswoman for the venture-capital firm declined to comment.Paul Yett, a managing director at asset-management firm Hamilton Lane, says some venture firms have been proactive about offering lower fees to investors. "Some have done it in a collaborative manner," he says.

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