Venture Capitalists Look for a Return to the A B C's

Brendan McDermid/Reuters

Marc Andreessen, left, and Ben Horowitz founded a software company and now have started a firm to invest in start-ups.

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SAN FRANCISCO — For a group accustomed to looking outward for the next big thing, Silicon Valley's venture capitalists are getting very introspective these days.

Much of the soul searching along Sand Hill Road in Menlo Park, where many of the venture capitalists have offices, is leading to the same conclusion: venture capital needs to go back to basics. The biggest names in the industry are concerned about low returns and are blaming several factors: funds that have grown too large, the M.B.A.'s that have invaded the industry and older partners who have lost touch with what is new in technology.

"I personally believe and I think the evidence proves that the venture industry has gotten too big, the funds have gotten too big," said Alan Patricof, an investor for 40 years who backed America Online and Apple, at a recent venture investing conference in San Francisco. "Our biggest challenge today for venture capital is to think smaller."

Mr. Patricof is part of a growing chorus of voices calling for the amount of money in venture funds to shrink drastically to levels last seen two decades ago. His firm, Greycroft Partners, is taking a retro approach with a $75 million fund that makes smaller investments.

Many in the industry predict that a third to a half of the 882 active venture capital firms could disappear, if only because poor returns will force underperforming firms to shut down. It is already happening: Investment in venture capital funds shrank to $4.3 billion in the first quarter, from $7.1 billion in the same quarter a year ago.

There will be “a ton of venture capitalists who disappear over the next 18 to 20 months, and it’s going to be painful for a while,” said Bryan Roberts, a partner at Venrock. “But the best thing that could have happened to V.C. is this economic crisis, because it’s lowering the flow of capital into these funds.”

The source of concern is lower returns brought on in part by a dearth of public stock offerings. Five-year returns in the venture capital industry, which reached 48 percent in 2000 at the height of the dot-com bubble, were just 6 percent through 2008, according to the National Venture Capital Association.

Most venture capitalists say the trouble began amid the excesses of the dot-com era. Before then, most of the investors in venture capital were university endowments, foundations and wealthy families. But in the late 1990s, endowments sharply increased their stake in illiquid assets, including venture capital. Big pension funds saw how much money these investors were making and wanted in as well. The amount invested annually by venture capitalists swelled to $104 billion in 2000, from $2.7 billion in 1990, according to the venture capital association. Today it is about $30 billion.

The surge of money is in large part to blame for the recent poor performance, many in the industry say. “The big financiers of venture capital are force-feeding the industry, and it’s like force-feeding cows — it makes the industry sick,” said Paul Kedrosky, a senior fellow at the Ewing Marion Kauffman Foundation who recently called for the venture industry to contract by half. “It’s a returns-driven business, and the only way you can post better returns is by shrinking.”

Instead of figuring out how much start-ups actually need, too many firms calculate how much they have in their funds, divide it by the number of partners and the number of boards they can sit on, and come up with a sum to invest in each start-up, said Ben Horowitz, a partner in a new venture firm, Andreessen Horowitz. That often means forcing $3 million into a company that needs $300,000, he said.

Overfinancing results in too many firms backing too many start-ups that do the same thing, some critics say, and it inflates the valuation of companies so that investors get smaller returns when they eventually sell.

The good news is that Web start-ups do not need as much money today, said Dana Settle, a partner at Greycroft Partners. “You can actually make a nice venture return if you sell them for less than $100 million, you just have to go in at the right price,” she said.

Greycroft has a $75 million fund, invests $500,000 to $3 million in each start-up and does not always demand a board seat. Neither does Andreessen Horowitz, which will invest as little as $50,000 in a start-up from its $300 million fund.

“That is a much better model than putting a bunch of money in upfront,” said Marc Andreessen, Mr. Horowitz’s partner.

Mr. Andreessen and Mr. Horowitz also attribute the venture industry’s struggles in part to the business school graduates who now populate Sand Hill Road offices, taking the place of the entrepreneurs who first formed venture firms. (Mr. Andreessen is a founder of Netscape, and he and Mr. Horowitz founded Opsware, a software company bought by Hewlett-Packard.)

When too many venture capitalists serve on a start-up’s board with “no proper judgment, who have never built a company,” they tend to get too involved in running the company and, in high-pressure situations, imagine problems that do not exist, Mr. Horowitz said. “Their insecurity and own anxiety filters into the advice,” he said.

Franklin Pitcher Johnson, a veteran venture capitalist known as Pitch who founded Asset Management Company in 1965, agrees. He had this advice for would-be venture capitalists at a recent conference: “Get a real job in an operating company, because what we back is operating companies — until you understand that, you can’t be much of a venture capitalist.”

Still others blame the fact that money flows to firms with the biggest past successes, even though the venture field can be an industry of one-hit wonders.

“The people who were venture gods in the 1990s are 10 years older than they were,” said Judith Elsea, co-founder and managing director of Weathergage Capital, which invests in venture funds. Experience is an advantage in any industry, but venture might be different, Ms. Elsea said, because “technology is so dynamic.”

Despite all the calls for a return to the old-school model of venture capital, some new technologies, like those in clean energy, require huge amounts of money, so some firms will need to remain large.

And certain investors dispute that too much money is the problem. Timothy Draper, founder of Draper Fisher Jurvetson, thinks there should be more venture capitalists, not fewer. “I don’t think we have enough venture capitalists to spread the wealth to the seven billion creative minds out there,” he said.