Risk (Aversion) Capital

from Soaring on Ridgelift by 1vc

Over the last two years I have seen a marked change in the willingness of my fellow venture capitalists to invest in early stage companies. It's become much harder for a small founding team with a business plan to raise money – almost regardless of the space.

Recently, articles have appeared such as "Venture Capital's Hidden Calamity" from BusinessWeek suggesting the the VC world is in crisis or "New VC Model For Small Scale Financing" by Bernard Lunn on Read/WriteWeb describing how the model needs to change.

It's worth taking a moment, stepping back and thinking about the different factors that are at work:

- Lack of exits
- Size of funds
- Pay up for proof

Lack of Exits

We're a long way from a robust IPO market – at a presentation yesterday by an investment banker, the suggestion was made that we'll probably see 50 or so IPOs this year – an improvement over the last couple of years but way short of even pre-bubble years where 150-200 companies went public each year. The average time to get from formation to IPO is now 6.5 years with the typical company going public having north of $100M in revenue, 15-20% pre-tax profit and growing 35+ percent year over year.

Acquisitions (which have always been the most likely way for investors to exit their investment) are also pretty unattractive as a way to get big exits.

Taken in combination, VCs are sitting on growing portfolios of companies which take time to manage even if the companies no longer need additional financing. As a result, there's not a lot of spare capacity to look at new deals and the bar for making a new investment has been raised significantly in terms of return potential, business plan and team.

Size of Funds

The average VC fund has become much larger - the amount of capital (per fund) that must be put to work by each partner has grown to $50M – about double what it was 10 years ago. With a lot of VCs already tight on time, increased capital means the VC has to look for opportunities where they can put larger amounts of money to work.

But there's a downside to putting more capital into an investment – more capital in means more capital must come out. The size of a "desirable" exit goes up as you raise more capital. This can

put management and investors at odds – both in terms of the strategy of the company (swing for the fences versus build as you go) and dealing with lower value M&A opportunities which might put good money in the hands of the management/employees/founders but not represent a good return for the investor.

Pay up for proof

Ask anyone involved with early stage companies and they will tell you that innovation is alive and thriving – there is no shortage of ideas, indeed no shortage of great ideas!

Faced with the pressures of exits, fund size and almost overwhelming deal flow, many VCs are changed their strategy to "watchful waiting" – let someone else fund the early round(s) of the company, wait until there are significant proof points that the company is succeeding and then pay up to invest in the next round.

Unlike the first two dynamics, this works in the favor of the entrepreneur (assuming you can raise money from angels or a VC that doesn't have the above dynamics!). Unfortunately it doesn't bode well for returns at the VC Fund level because the exit dynamics remain the same!

Like Mark Twain, reports of the death of venture capital are greatly exaggerated but many VC funds are on the horns of a dilemma – morph strategy to cope with these dynamics or raise smaller funds.

For the entrepreneur and those of us committed to work with companies very early on, there are some key take-aways:

1. Raise less money up front.
2. Identify milestones around market, team and technology that remove risk and build value –then achieve them before raising more money!
3. Match the capabilities of your investors (Fund size AND expertise) to the capital requirements of your company.
4. If you have a capital intensive business, face the fact that you are embarking on a longer (and likely riskier) journey – hopefully the risk/reward equation will solve and make your journey worthwhile.

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Venture Capital's Hidden Calamity

A closer look at otherwise strong investment growth shows many firms are getting all the drawbacks of a hot market, with few of the benefits
By Sarah Lacy

Business Week
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This is a bad time to be a venture capitalist. Anyone who says different is raising a new fund -- or works at one of the few firms having a good year.

Sure, the numbers look great on the surface. The value of deals rose a solid, yet not bubbly, 8% in the second quarter, with investors pumping $7.4 billion into emerging companies, according to Dow Jones VentureOne. And the money is funding some legitimately exciting frontiers, including Web 2.0, which attracted $500 million in the first half. Companies specializing in clean tech got $1.1 billion in the same period.

Initial public offerings are up for the year, too. In the second quarter, venture-backed companies tapped the public markets for $2.73 billion, the most raised in a three-month period since the go-go days of 2000. And researchers expect the current period to be another banner quarter, with a whopping 46 companies looking to file.

IPOs and Acquisitions Tell a Different Story

But a closer look at the numbers reveals some disturbing trends. Consider IPOs. Most of the initial share sales getting done are mainly one-off companies that were founded years ago and have slogged away at building solid businesses for a half-decade or more. This year's biggest hits were MetroPCS (PCS) of Dallas and EMC's (EMC) spin-out of VMware (VMW) --

hardly your classic Silicon Valley startups. There's simply no big overall tech movement getting Wall Street revved up, and among entrepreneurs, the feeling is mutual. Sarbanes Oxley and other regulations have made the prospect of going public far less appealing.

The picture looks worse among acquisitions. Sure, the usually sleepy third quarter saw $10 billion come in acquisition proceeds, but that was spread among 90 deals. Companies like TellMe, the voice recognition software company founded in the late 1990s that snagged $800 million from Microsoft (MSFT), are in the minority this year. Far more common is the tech company that plodded along for more than six years, chewing through some $30 million in venture cash to eventually get bought for $50 million or so. Indeed, the median length of time it took companies to get bought was the longest Dow Jones VentureOne has seen since it started measuring the industry 20 years ago. Meanwhile, valuations keep rising, as billions of dollars in VCs coffers fight to get in what few great companies are out there.

Upheaval Ahead

It's not that venture firms are destitute. They've got plenty of base hits. But the home runs are increasingly elusive. And venture capital is a home-run business, where the top 10% firms make up nearly 80% of the returns.

Internally, many investors are worried that only a handful of firms will break even on the current crop of funds, much less post stellar returns. In hushed conversations over breakfasts at Buck's and lunches at the Sundeck, VC veterans are wondering aloud whether they should get out, or, after years of playing boardroom quarterback, whether they've still got the chops to actually build a startup.

However you slice it, unless something changes, venture capital is in for upheaval. Some venture capitalists are going to find themselves out of a job. Overall, the industry may become more the font of outsourced research and development for big firms and less the breeding ground for the next great tech powerhouse. And returns will be lackluster for the majority of firms left out of the best deals.

Smaller Stakes

The current calamity has been a long time in the making. After the NASDAQ party ended, firms learned the hard way that you could no longer take companies from idea to public in 18 months. Not only is it a business of building companies, it's a business about people, gut calls, and the art of building a portfolio one deal at a time. That's why scores of firms that had raised $1 billion-plus funds wound up returning hundreds of millions in uninvested money back in the early '00s.

But even as many firms were voluntarily downsizing, those investing in the venture industry as a whole -- the world's largest pension funds and institutions -- only wanted to invest in venture firms more. Money wanted to get into a shrinking business, giving marginal firms another shot and keeping any Darwinian shakeout at bay. "Venture capitalists are still living in 1999," says Peter Thiel, former PayPal Chief executive and founder of hedge fund Clarium Capital and venture fund The Founders Fund.

The fallout is still being felt, even in what are considered hot sectors. Take Web 2.0, where exactly one company, YouTube, had a $1 billion-plus outcome when it was purchased by Google (GOOG). Only a handful has sold in the hundreds of millions. And because the costs of starting these businesses are so low, venture investors own smaller stakes than they did in the last Web bubble.

Paper Gains

Clean-tech companies have seen a few exits, with two IPOs this year and three in registration. Still, the deals have been small. Most of the Clean-tech market is still experimental, in both technology and market opportunity.

Meanwhile, venture investors are paying more to get into the best deals. A recent study by Valley law firm Fenwick & West showed that valuations are on the rise. Valuations are an important barometer of who holds more power at any given point in the Silicon Valley economic cycle. The higher a valuation, the fewer shares a VC's dollar buys, and the more leverage entrepreneurs have.

High valuations aren't all bad news for the venture set. Step-ups in valuations between rounds, for instance, mean that on paper, early-stage investors are showing gains. But so far, that's just on paper. Typically, valuations are driven up by the prospect of a big acquisition or IPO. Now, they're mostly being driven up by the piles of money looking for the next hot deal. Venture investors are getting all the drawbacks of a hot market, with competition to get in on deals and high prices, without the benefits -- a rash of blockbuster IPOs and acquisitions.

Oodles of Cash

Heading into this year, a study by the National Venture Capital Assn. found that almost half of venture investors surveyed predicted a decrease in the number of VC firms even as returns improve overall. "The pundits were correct about the reduction in venture capital firms -- they were just a few years too early," Mark Heesen, head of the NVCA, said at the time of the survey.

Indeed, other studies have shown that terms between venture guys and their investors are getting harsher, as limited partners increasingly demand lower management fees and so-called "key man" provisions, which give investors an out if certain rock-star partners leave a firm. The most staggering example of the tension was the recent news of Yale getting kicked out of top Valley firm Sequoia Capital's newest fund after refusing to invest in the firm's less-proven overseas and late-stage funds.

There is a bright side. With so much cash floating around the Valley, entrepreneurs have never had it so good. Sure, a lot of dumb ideas are getting funded, but nearly any great idea has a good chance of getting funded, too. There is likely a trove of new experiments being started on the sly. And ultimately, VCs will fund these deals, and that top 10% will continue to have huge hits with returns that the NASDAQ, bond markets, and even buyout firms can't match.

The question is, in an industry that has gotten this big and this bloated, how long do the other 90% and their investors keep hoping for the next winning lottery ticket?

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New VC Model For Small Scale Financing

Written by **Bernard Lunn** / October 11, 2007 / **5 comments**

There is a great meme circulating about how the VC industry needs to adapt to a world with massively lower barriers to entry.

Paul Graham - from YCombinator - who is leading this change more than anybody has the definitive post. Its worth a careful read. Fred Wilson, from a more traditional but still very innovative VC (Union Square Ventures) agrees with the general trend and is well positioned to play by the emerging new rules.

There is a wonderfully entertaining rant by Dave McCLure about how VCs had better get with the program or else. He hits a very serious point about standardisation of deal terms and online closing process being essential. Here is another clearly heartfelt post that would probably be echoed by a lot of entrepreneurs.

When I first heard about YCombinator, I thought "incubator" and even worse "drive by VC", both late cycle excesses in the Web 1.0 boom that led to a lot of capital destruction (in small chunks of course). As is so often the case, when history repeats itself, it does so with a surprising twist. Which now makes me think that this might be a sustainable new model.

The model clearly has almost nothing to do with traditional VC. The big "VC aristocrats" (aka "Tier 1") with their $multi-billion funds and huge success stories behind them will almost all say that it is classic late stage bubble excess. At some level they have to think this as they certainly cannot play in the new rules where $300k might be a Series A.

Many of the Tier 1 players, who made their fortunes in IT, are also generally thinking, along with Nick Carr, that IT Does Not Matter. They believe that the big wave of opportunity has moved onto frontiers such as CleanTech and personalized medicine.

The A&R model from the music industry offers some interesting parallels for this new world of lots of small web start-ups. A&R (Artist & Repertoire) defined by Wikiepdia as:

"In the music industry, Artists and Repertoire (A&R) is the division of a record label company that is responsible for scouting and artist development. It is the link between the recording artist/act and the record label, generally to help with the artistic and commercial development of the label's artists. An A&R person is often required to handle contractual negotiations, find songwriters and record producers for the act, and schedule recording sessions."

In this new world the A&R function - scouting and entrepreneur development - is done by new style VCs such as YCombinator, angels and angel networks. They are independent of the "record label", which we can now think of as the big platform acquirers (GYM and the newly energized AOL and maybe soon Facebook - making a rather unpronouncable GYMAF), but they have good connections with these platform companies when it comes time to exit.

The A&R guy would hang out in the Clubs checking out new bands. Years of experience gave them great intuition to make quick judgement calls, essential when a bit of dithering might mean you went down in history as "Decca Records turning down the Beatles". The most fundamental skill however was a well tuned ear for the "clapometer", seeing the enthusiasm of the audience at first hand in a tiny basement and extrapolating from there to Shea Stadium.

Like any analogy it cannot be stretched that far, but it does fit some recent trends, particuarly the trend to younger entrepreneurs. Fred Wilson kicked up a storm a few months ago when he simply observed that they were seeing a lot more young entrepreneurs. Young people obviously know better what appeals to other young people.

More fundamentally, the music business and this new start-up model have fundamentally different power laws to traditional VC. "Classic VC" worked on a portfolio with say 10 deals, 1 could be a megastar, 3 reasonable returns, 3 make their money back and 3 bomb totally - or some variant on that theme. The new model might have 100, but still only 1 megastar. There is only one top of the charts or only one Google/Facebook/eBay. That sounds like a bad deal but it is not because the returns to the megastars are massive, many will make a reasonable income (derided by VC as "lifestyle businesses") and even the weak ones can get sold to at least recoup the money.

The maturity of "pay as you go infrastructure" changes the financing rules dramatically. You don't need to use precious equity to finance capital expenditure. You use a small amount to build the service and get some traction. By the time you need to scale the risk profile is dramatically different. This is where quasi-debt structures are likely to evolve (i.e. with some Warrants so the debt provider gets a small equity ("kicker"). It is like the record company saying "wow the kids love this, crank up the presses".

This new model also dramatically changes what the entrepreneur needs from their VC in addition to cash. In Enterprise IT, the VC's "golden Rolodex" and reputation was worth more than the cash; it signalled "survivability" to a CIO burnt by doing deals with start-ups. In the new era many sites don't even bother with About Us, as the decisions are taken one click at a time based solely on the value of the service.

The new VC may show some additional value by advising on how to scale and maximizing valuation on exit. These are valuable but not mission critical.

The sustainability of this new model is based on three fundamentals:

1. The continued evolution of mature web standards so that new services can easily be "plugged and played" in the acquirers platform. This trend looks pretty solid. It should be a key financing criteria.

2. The continued growth of online advertising. The gap between time spent online and $$ spent online is still "big enough to drive a truck through" so this should be OK. There is still a lot of innovation needed to generate engagement and to demonstrate measurability - but that will probably happen and "is another story".

3. GYMAF and other large companies continue to fail to meet the emerging trends with internal R&D and therefore will always be willing to pay a premium to acquire from outside. This trend looks solid. It has been true for decades and is even more true when the next "hit" is completely outside the normal range and is so dependent on fickle consumer taste. Record companies that tried creating their own bands ended up with The Monkees (and that was the success story!).