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[What Is Really Happening to the Venture Capital Industry?](#)

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Many are speculating that the year two thousand and nine represents a fundamental turning point for the venture capital industry. Some are arguing that [the industry is in dire straits](#) after years of poor performance. Others have argued that [the math simply does not work](#) for the industry's current size. Another theory suggests that [permanent challenges with the IPO market call into question the fundamental economics of the VC industry](#). Lastly, some [credible authors have suggested](#) that things are so bad that a federal bailout may be in order.

What is really happening in the venture capital industry? It is indeed quite likely that the venture industry is in the process of a very substantial reduction in size, perhaps the first in the history of the industry. However, the specific catalyst for this reduction is not directly related to the issues just mentioned. In order to fully understand what is happening, one must look upstream from the venture capitalists to the source of funds, for that is where the wheels of change are in motion.

Venture capital funds receive the majority of their funds from large pension funds, endowments, and foundations which represent some of the largest pools of capital in the world. This "institutional capital" is typically managed by active fund managers who invest with the objective of earning an optimal return in order to meet the needs of the specific institution and/or

to grow the size of their overall fund. These fund managers have one primary tool in their search for optimal returns: deciding which investment categories (referred to as “asset classes”) should receive which percentage of the overall capital allocation. This process is known in the financial field as “[asset allocation](#).”

Asset allocation is the strategy an investor uses to choose specifically how to divide up capital amongst asset classes such as stocks, bonds, international stocks, international bonds, real-estate funds, leveraged buys-outs (LBOs), venture capital, as well as other obscure classes such as timber funds. Some of these asset classes, such as stocks and bonds, are known as “liquid assets,” because these instruments trade on a daily basis on exchanges around the world. For these assets, investors can be quite sure of the exact value of their holdings, as the price is set continuously in the market. Also, if they need to sell, there is a ready market to accept the trade. Illiquid assets, also known as alternative assets, include all the other investment classes that do not trade on a daily exchange. These “private” investments (as compared to “public” liquid investments) are considered higher risk due to their illiquidity, but also are expected to earn a higher return. Some hedge funds are included in alternative assets either because they themselves invest in illiquid investments or because they put strict limitations on the trading capability of the institutional investors, rendering themselves “illiquid”.

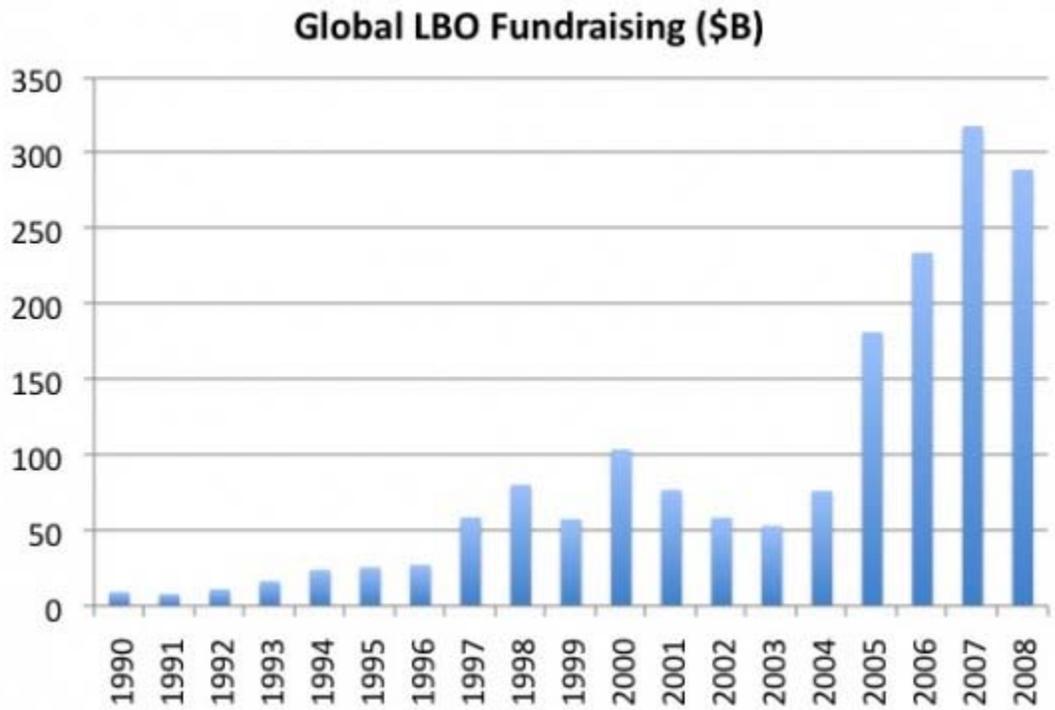


Asset allocation is a well-studied area within the field of finance. A prototypical U.S.-based asset allocation model might allocate 25% to U.S. stocks, 30% to U.S. debt, 25% to international equity and debt, and let’s say 20% to all alternative assets. Within alternative assets, LBOs might be 60%, and venture capital could be as low as 10% (of the 20%). As a result, venture capital could be as low as 2% of a institutional fund’s overall capital allocation. Most people fail to realize just how small venture capital is in the overall scheme of things.

Very generally speaking, experts and academicians have considered it “conservative” to have a smaller allocation to all alternative assets reflecting the risks of illiquidity, the inability to ascertain price, and the higher difficulty in analyzing the non-standard vehicles. It is a fairly straightforward, conservative investment approach to favor liquidity and certainty over absolute potential upside (this is the same argument for holding bonds over stocks).

Over the past decade or so, a large number of very influential institutional funds have substantially increased their allocation in alternative assets. In some extreme cases, these investors have taken this allocation from a conservative amount of say 15-20% to well over 50%

of their fund. Many people suggest that [David Swensen](#) at Yale was the original architect of a strategy to adopt a much higher allocation to alternative assets. Regardless of whether he was the leader or not, several funds simultaneously adopted this higher-risk, higher-return model. (For a more detailed look at how this evolved and why, see [Ivy League Schools Learn a Lesson in Liquidity](#) and [How Harvard Investing Superstars Crashed](#). For an even deeper dive including comparative asset allocation models see [Tough Lessons for Harvard and Yale](#).)



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g to this dynamic on the field, the early movers to this model were able to post above-average returns.* Also, due to the high disclosure policy of most universities, these above average performances were often touted in press releases. This “public benchmarking” put further pressure on competing fund managers who were not seeing equal returns, which as you might guess, led to them mimicking the same strategy. As a result, alternative assets have grown quite substantially over the past ten years. This is perhaps best seen in the size of the overall LBO market. The included chart shows the money raised in the LBO market over the past 30 years. As you can see, the amount of dollars pouring into this category over the past five years is nothing short of breathtaking.

The market contraction of late 2008 and early 2009 severely compromised the high-alternative asset allocation strategy. The liquid portion of average portfolio contracted as much as 30-40%, which had two resulting impacts. Initially, this resulted in most fund managers having an even higher portion of their funds in illiquid investments. Ironically this was largely an accounting issue. Most likely, the illiquid pieces of their portfolio had declined just as much, but as illiquid investments are not valued on a day-to-day basis, they simply were not properly discounted at this point (over time they “would” and “are” eventually coming down). But with one’s fund already down 30% or so, no one is eager to further decrement the value. Despite that this may have only been an “accounting” issue, it presented a problem nonetheless, as many fund

managers have triggers that force them to reallocate capital if they go above or below a certain asset allocation. This is one of those policies that encouraged selling at a point that may be the exact wrong time, contributing to further declines.

A second and more complicated problem also emerged. It turns out that when an institutional investor “invests” in an LBO fund they don’t actually invest the dollars all at once, rather they commit to an investment over time, which is “drawn down” by the LBO manager (venture capital works in the same way, but once again is a much smaller category). As these funds substantially increased their commitment to the LBO category, they were de facto increasing a guaranteed negative cash flow in the future to meet these draw-downs. Now, with portfolios out of balance, and lack of new liquidity events from the M&A and IPO markets, these funds have cash needs (to meet the draw-downs) that are not offset by cash availability. If anything, the universities and endowments these managers represent want more cash now to deal with the difficult overall economic environment.

To meet these new liquidity needs an institutional investor could:

1. Sell more of its liquid securities. This is problematic because it further compromises the target asset allocation.
2. Try to sell the LBO commitments on the secondary market. As you might suspect the secondary market is extremely depressed. Some have even suggested that due to the forward cash need on an early LBO fund, an institution might have to “pay” to get out of the position, and to encourage someone else take on the future cash commitment.
3. Default on the commitment. While this does have penalties in most cases, it would not be out of the realm of possibilities for this to occur if the investor has lost faith in the manager, and it is early in the fund (with more cash needs in the future).
4. Try to raise more capital. Not surprisingly, donations to foundations and universities are down dramatically due to the overall decline in the capital markets. This makes this strategy unlikely.

As you can see, none of these options are overly compelling.

If this is not bad enough, many institutional fund managers and the groups to whom they report (such as a board of trustees) are now second-guessing the high-alternative asset allocation model. As a result, they may desire to return to the more conservative and more traditional asset allocation of 10-20% allocated to alternative assets. Ironically, they are in no position to rebalance their portfolio precisely because they lack incremental liquidity. Think about it this way – it is very easy to shift a portfolio from liquid assets to illiquid. You simply sell positions in highly liquid securities, and buy or commit to illiquid ones. Going the other way is not so simple, as there is no ability to conveniently exit the illiquid positions.

This is a very long explanation, but the punch line is that as these large institutions adjust their portfolios and potentially abandon these more aggressive strategies, the amount of overall capital committed to alternative assets will undoubtedly shrink. As this happens, the VC industry will shrink in kind. How much will it go down? It is very hard to say. It would not be surprising for

many of these funds to cut their allocation in the category in half, and as a result, it shouldn't be surprising for the VC industry to get cut in half also.

One could argue that poor returns in the VC industry is the primary reason the category will shrink and that, as a result, the VC industry could be cut even further – or perhaps even go away. There are two key reasons that this is highly unlikely. First, one of the key tenets of finance theory is the [Capital Asset Pricing Model](#) (CAPM). The CAPM model argues that each investment has a risk, measured as Beta, which is correlated with return vs. that of the risk-free return. Venture Capital is obviously a high-Beta investment category. As of August 3rd, 2009, the [S&P 500 has a negative 10-year return](#). As a higher-Beta category, no rational investor could reasonably expect the VC industry as a whole to outperform in a catastrophic overall equity market. In fact, the expectation would be for lower returns than the equity benchmark. This multiplicative correlation with traditional equity markets is the exact same reason that venture capital outperformed traditional equities in the late 1990's. The bottom line is that no institutional investor should be surprised by the recent below-average performance of the entire category, all things being equal.

The second reason the category will not be abandoned is contrarianism. Most students of financial history have read the famous quote attributed to Warren Buffet, "*We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.*" One of the biggest fears of any investor is to abandon an investment at its low point, and then miss the corresponding recovery that would have helped offset previous poor returns. While this mindset will not guarantee the 100-year viability of the venture capital category, it should act as a governor on any mass exodus of the category. The more people that exit, the more the true believers will want to double-down.

So when will this happen? One thing for sure is it will not happen quickly. The VC industry has low barriers to entry and high barriers to exit. Theoretically, a fund raised in 2008, where all the LPs have no plans to commit to their next fund, may still be doing business in 2018. VC funds have long lives, and the point at which they decide to "not continue" is usually when they go to raise a new fund. This would typically be 3-5 years after they raised their last fund, but could be expanded to 5-7 years in a tough market. In some ways the process has already started. Stories are starting to [pop up about VC funds that were unable to raise their next fund](#). Also, some entrepreneurs are starting to discuss favoring VCs of which they can be confident of their longevity. All in all, one should expect a large number of VC firms to call it quits over the next five years.

How should Silicon Valley think about these changes? It is important to realize that there are approximately 900 active VC firms in the U.S. alone. If that number fell to 450, it is not clear that the average Silicon Valley resident would take much notice. Another interesting data point can be found in the NVCA data outlining how much money VCs are investing in startups (as opposed to LP's committing to VC firms). [VC firms invested about \\$3.7B in the second quarter of 2009](#). Interestingly, this number is about half of the recent peak of around \$8B/quarter. It is also quite similar to the investment level in the mid 1990s, prior to both the Internet bubble, and the rise of the aggressive asset allocation model. So from that perspective, *this*, meaning the investment level we see right now in Q2 of 2009, may be what it is going to be like in the future.

There are many reasons to believe that a reduction in the size of the VC industry will be healthy for the industry overall and should lead to above average returns in the future. This is not simply because less supply of dollars will give VCs more pricing leverage. We have seen over and over again how excess capital can lead to crowded emerging markets with as many as 5-6 VC backed competitors. Reducing this to 2-3 players will result in less cutthroat behavior and much healthier returns for all companies and entrepreneurs in the market. Additionally, at a stabilized market size of well over \$15B a year, there should be plenty of capital to fund the next Microsoft, Ebay, or Google.

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** To date, it is unclear if these “above-average” returns were a result of the liquid half of these portfolios or the illiquid half. As we mentioned earlier, it is extremely difficult to ascertain the actual value of an illiquid investment. In many cases, the institutional fund manager relies on the investment manager of the asset in which they invested to prescribe a value to the investment, even though they may be highly biased. If it turns out a large portion of the “above-average” returns of these early adopters of this more aggressive strategy were on the illiquid side, we may have yet again another example of the dangers of mark-to-market accounting.*