

## Venturing On

by Kent Bernhard, Jr. Sep 30 2009

It's tough out there for venture capitalists to earn money on the companies in which they've invested, and the latest numbers show it. Still, tough times haven't dampened the optimism of those in an industry built on risk taking and innovation.



There's no shortage of the kind of genius exhibited by Albert Einstein, venture capitalists say. The trick is turning that genius into profits.

It's a tough time to be a venture capitalist, and the latest numbers show it.

You're getting hit from both sides. The markets for all those companies you've invested in and nurtured are anemic at best. That means you're going to have a hard time cashing out with either an initial public offering or by selling your portfolio company to another company. And the atmosphere has turned chilly for raising money from limited partners to invest in more companies or keep the ones you've got going.

"I think really what's going on is it's an industry in total flux," Jim Koshland, chair of the venture capital practice at DLA Piper, a Silicon Valley and global law firm. "The venture world believes they're going to shrink substantially."

There were only three venture-backed initial public offerings so far in the third quarter, a drop from five in the second quarter, and that wasn't exactly a barn burner of a quarter. According to a report by the National Venture Capital Association and Thomson Reuters released this morning, the three IPOs through the end of September were worth \$572.1 million. So far this year, there have been eight venture-backed IPOs in the U.S. That's better than 2008, but it's still far from a healthy market.

"The fact that many in the media are classifying three IPOs as resurgence is evidence of how low our expectations have become," said Mark Heesen, president of the NVCA, in a statement. "While we are encouraged by the success of the companies that have gone public, their performance has yet to translate into a filling of the pipeline."

But there was a silver lining. One U.S. IPO, that of A123 Systems, which is working on batteries for electric cars, weighed in at \$380.4 million, enough to give some hope that an IPO rebound may be beginning. It was the largest venture-backed IPO since 2007.

And, according to Dealogic, in a different report released to Portfolio.com this week, there were six venture-backed IPOs in China and two in Japan in the third quarter; none of them worth more than \$100 million. Still,

the Chinese IPOs point to a theme venture capitalists say is emerging—a healthy IPO market in the Pacific Rim, especially China.

“I believe the industry will continue its pace of becoming a more globalized industry,” said venture industry veteran Dixon Doll, co-founder and general partner at DCM. “If you look at the Chinese market, it’s kind of roughly where the U.S. market was in the early to mid-'80s. You can just project outward that the Chinese market is going to grow significantly over the next five years.”

Through September in the third quarter, there were another 62 mergers and acquisitions of venture-backed companies, with 21 of those deals adding up to \$1.2 billion, according to the NVCA Thomson Reuters report. Information technology companies dominated the M&A landscape, with 51 deals worth \$1.1 billion.

But both means of cashing out are far from healthy.

“We had a basic freezing up of the capital markets during late 2007 and 2008,” says Doll. “We had begun a slow but steady recovery of the IPO market,” following the tech bust of the early part of the decade. There were 75 venture-backed IPOs in 2007, “about half of what we’d like to see. Then the window slammed shut.

We’ve got to get public offerings and M&A back on a reasonable footing. Then we should see the venture industry returning to a much more normal operating cycle than we have in the last 18 months.”

At the same time, the pool of limited partners willing to invest in venture capital is shrinking. Endowments are drained, and the portfolios of wealthy people and pension funds have been hammered by the general financial-market meltdown.

Venture firms raised \$1.7 billion in the second quarter, the least in more than seven years. Only 25 firms raised money. Venture capitalists raised less than one fifth of the 2008 second-quarter total of \$9.3 billion. More recently there have been some signs of life, with Vinod Khosla’s Khosla Ventures recently raising a \$1.1 billion fund.

So all of that’s the present. But what’s the venture capital industry going to be like five years from now? That’s what Portfolio.com asked 10 venture capitalists from around the nation.

Most thought it would be a smaller industry, with smaller funds and fewer venture partners. But that’s not necessarily a bad thing, they say. They predict healthy funds will be able to return healthy results, and that smaller size could lead them to make better, more targeted investments in companies that truly have the capacity to become world changers like Google or Microsoft.

And they think that, for the venture capitalists with money to invest now, the companies they are growing could be looked upon as one of the great crops when they come to maturity. And there are still plenty of companies to invest in.

“Good firms that find ways to reinvent themselves,” says Doll of DCM, “and make strategic changes to stay in sync with what’s going on in the world, they’ll thrive and flourish. We don’t see any evidence at all that innovation is slowing down or coming to the end of its existence. There’s just a ton of evidence that innovation is alive and well. History also has taught us that times like we’re in right now are very good times for starting new companies because there’s a plethora of good talent.”