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Venture capitalists today look far and wide for start-ups

By Edward Iwata, USA TODAY

While others toiled in the technology mecca of Silicon Valley, Trevor Loy — a former Intel manager and Stanford University-trained engineer — pursued the digital road not taken.

Nearly a decade ago, he moved to the New Mexico desert to co-found a small venture-capital firm called Flywheel Ventures. His aim: to find the next generation of start-ups where few others were looking.

Tapping into the wealth of technology talent and research in the region surrounding the Sandia and Los Alamos federal research labs, Flywheel Ventures has invested \$34 million in 19 companies in solar, biofuel and other sectors. Most of the start-ups were "born global," Loy says, with U.S. and overseas offices, employees and customers.

One promising find off the beaten tech track: Miox, an Albuquerque firm that makes water-disinfectant generators that use salt and electricity, not potentially dangerous chlorine gas. Miox — which just received \$19 million in funding from DCM, Sierra Ventures and Flywheel Ventures — has water-treatment installations in 30 countries.

"This is the natural evolution of our industry," the 37-year-old Loy says. "Venture capital has matured and reached critical mass in some markets, and now we're seeing explosive growth and opportunities elsewhere."

The nearly half-century-old U.S. venture industry appears to be entering a new era — what some call Venture Capital 2.0. Powerful forces, from economic globalization to weak markets for initial public offerings and acquisitions, are sweeping the industry and causing much soul-searching. To grow and survive, venture firms large and small are hunting for new global entrepreneurs and markets, and for fresh investment sectors such as clean technology and alternative energy.

Some venture capitalists believe that their traditional industry model needs shaking up. Over the decades, U.S. venture firms have poured hundreds of billions of dollars into thousands of young tech firms. Most died or failed to grow, while others — Intel, Apple, Amazon.com, Google — grew into business giants.

Since the dot-com boom and its 2001 bust, venture investment returns in the USA have dwindled. Too many venture firms and too much capital are chasing too few prized start-ups, many say.

Dileep Rao, a University of Minnesota entrepreneurship professor, contends that venture investing is mostly "a lottery system" won by a lucky few. He says that elite venture firms — about 4% of all firms — haul in most of the profits with big IPOs and acquisitions, while returns for others pale by comparison.

Venture capitalists, he says, "need home runs such as Google and eBay to reach their financial goals, but there are not enough high-potential ventures to satisfy the large numbers of VC funds."

Venture investors focus narrowly on short-term investments and what they believe to be the Next Big Thing, contends Tom Simpson, founder of Northwest Venture Associates in Seattle.

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Instead, they should seek steady, long-run growth in young companies. Starbucks is a prime example of a former start-up that resisted the early temptation to sell its stock until the company enjoyed steady profits and growth, says Simpson, whose firm manages \$170 million in venture investments.

The debate comes at a tough time for venture firms, as the usual "exit strategies" for venture-backed young companies have dried up in the USA.

Mergers and acquisitions in the second quarter of 2008 fell 59% from the same time last year, says Dow Jones VentureSource.

And there were no venture-backed initial public offerings — when private companies "go public" and sell stock — in the second quarter, reports the National Venture Capital Association. That's the first time that has happened in 30 years.

With no way to cash out of their start-up investments, venture capitalists say they must continue raising millions of dollars to sustain the young companies in their portfolios.

"It is like having a family of children that are still living at home in their 30s," Simpson says. "The traditional VC model and mentality does not effectively accommodate this new 'buy and hold' reality."

Not surprisingly, venture capitalists are gloomy about the near future. Their confidence last month fell to record low of 3.0 on the 5-point scale of the Silicon Venture Capitalist Confidence Index, a quarterly survey by University of San Francisco entrepreneurship professor Mark Cannice.

Many Internet and software investments — core of the venture-capital industry for years — have hit a point of limited returns, say venture capitalists such as Josh Kopelman, managing partner at First Round Capital in West Conshohocken, Pa.

Take a typical \$400 million venture fund, he says. For the fund to enjoy a 20% annual return over six years, it roughly would have to triple in value to \$1.2 billion.

"The numbers just don't work," Kopelman says. "You've got a whole generation of venture capitalists who have never made money from their funds."

Over the past 30 years or so, U.S. venture capitalists and investors have enjoyed attractive returns of 17% to 18%, says Josh Lerner, a Harvard Business School professor and co-author with Harvard colleague Paul Gompers of *The Money of Invention: How Venture Capital Creates New Wealth*. Returns peaked at 190% during the dot-com boom in 1999 and hit 20% last year.

The investments are high-risk, though, and the most lucrative returns are taken by mostly larger venture firms, Lerner says. And returns have slowed in recent years because of the weak financial markets.

Some falling out

A shakeout in the industry already is starting, according to venture capitalists. More than 1,000 venture funds sprouted during the dot-com era, but many of those will shrink or be absorbed by other funds, says Gompers. About 500 or 600 funds — the level of the 1980s — would be healthy for the industry, he says.

At the same time, the venture industry is growing abroad. Venture capitalists in Silicon Valley once joked that they'd never invest in a start-up more than a 15-minute drive away. Not now.

Increasingly, Silicon Valley venture firms such as Draper Fisher Jurvetson and Sequoia Capital are looking beyond U.S. tech hotspots and investing from Dubai to Dublin. Since 2001, U.S. venture firms have raised \$230 billion in venture capital worldwide — with \$40 billion coming last year, according to Ernst & Young.

Of course, U.S. companies have long dominated IPOs. But in the first half of this year, only one — Visa — made the Top 10 IPOs in the world. The rest are based in China, Brazil, India, Saudi Arabia, the United Kingdom and other countries, according to IPO research firm Renaissance Capital.

"Entrepreneurship and innovative technology has gone global," says DFJ managing director Raj Atluru. "Back in the early 2000s, a software engineer in India was maybe two years behind us. In 2005, he was six months behind us. Now, I don't think there's any difference."

At DFJ, one-fourth of its core venture fund invests in foreign-based start-ups, including thriving search-engine firm Baidu, often called "the Google of China."

DFJ also oversees a widening network of 20 foreign "partner funds" run by venture capitalists and investors from Asia to Europe. Managing

director Don Wood says the DFJ-branded funds manage \$6 billion in investments and are seeing "strong deal flow and a steady flow of exits" via IPOs and acquisitions.

Higher standards

As the economic slump drags on, venture firms are more closely scrutinizing their investments, funding only meaner-and-leaner start-ups.

During the IPO frenzy of the dot-com era, tiny start-ups with barely a few million dollars in sales typically rushed to market to sell their stock. Today, though, young companies must boast seasoned management teams, strong products and tens of millions of dollars in sales. They prudently manage their cash, not recklessly burning through it.

Then, after five to eight years, they're primed to go the IPO route or be acquired by a bigger company. Even the slow economy gives start-ups the chance to streamline their business and toughen themselves.

"The goal is to build real companies," says Matt Trevithick, a partner at Venrock Venture Partners in Menlo Park, Calif. "Successful companies in good or poor markets will remain successful companies."

A new breed of U.S. entrepreneurs — not weaned on short-term IPOs and lucrative stock options — hope to grow their start-ups into larger corporations in the tradition of Dell and Microsoft, says Mark Heesen, president of the National Venture Capital Association. And that's a good sign for the long-run health of the tech industry, he notes.

Moreover, as the U.S. economy and industries mature, Venrock and other venture-capital firms are stepping up the search for new investments in faster-growing sectors.

For decades, U.S. software and the Internet have been by far the largest sectors for venture investments. Now, though, venture firms also are investing more in energy, the life sciences and clean technology, which includes start-ups developing new environmentally friendly technology.

Energy use globally is rising, and more companies and consumers are looking at alternative fuels and greener cars and products, says Joseph Muscat, Ernst & Young's Americas director of venture capital and clean tech.

Last year, VCs poured a record \$3 billion into more than 200 clean-tech deals in the USA, China and Europe, says Dow Jones VentureOne. "This is very much the beginning of a long-term trend," Muscat says.

In Seattle, venture capitalist Simpson believes that the standard venture investment fund should be what he calls an "evergreen fund" that invests patiently in young companies with strong cash flow, rather than cashing out quickly in three or four years.

Evergreen funds would offer investments in start-ups from a much wider range of sectors and geographies than traditional venture funds. Investors also would enjoy financial gains earlier by receiving dividends, rather than waiting many years for an IPO.

Natural evolution

Whatever the new era may bring, venture capitalists say, their industry model isn't dying, merely evolving.

Business innovation still thrives during downturns. First-rate entrepreneurs are emerging in many countries. Investment capital keeps flowing across borders. Their industry, they believe, will spring back strongly once financial markets rebound.

"The VC model is always going through transformation," Muscat says. "That's the very nature of venture investors ... and it is fundamental to the industry."

Venrock illustrates VC's shifting focus. Founded as the venture arm of the Rockefeller family to invest in aviation before World War II, the Palo Alto, Calif.-based firm has since poured \$2.2 billion into 400 companies.

Now Venrock is prowling overseas for clean-energy, technology and health care companies. Venrock and a syndicate of venture firms recently invested \$24 million in British start-up Orecon, which makes a buoy-like wave-energy device that generates electricity for 1,000 homes.

"We spend an awful lot of time in airplanes," Trevithick says.

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