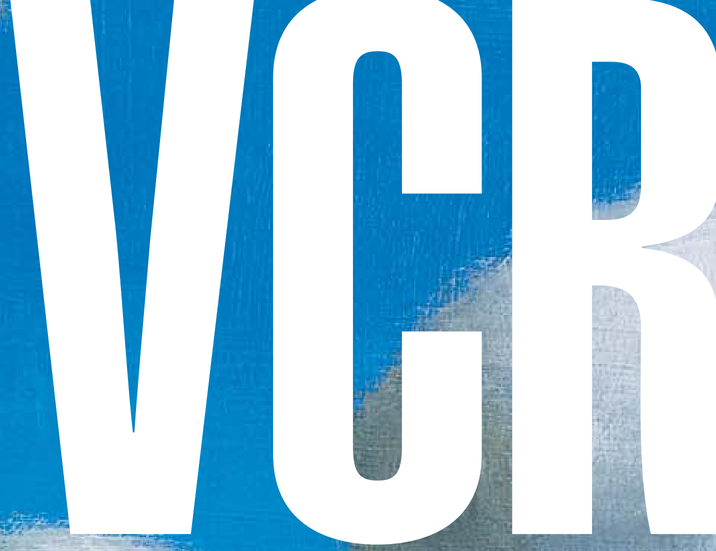

VENTURE CAPITAL REVIEW

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National Venture Capital Association (NVCA)

The National Venture Capital Association (NVCA) represents more than 400 venture capital and private equity organizations. NVCA's mission is to foster the understanding of the importance of venture capital to the vitality of the US and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, to facilitate networking opportunities and to provide research data and professional development for its members.

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PROBITAS PARTNERS

Limited Partners' Perceptions of the Venture Capital Market and the Fundraising Dynamic

By Craig Marmer, Founding Partner, Probitas Partners

KEY POINTS

- The venture capital market is witnessing a number of secular trends that are challenging limited partners' commitment to the sector.
- The fundraising market has been challenging due to the global economic environment and is likely to remain difficult in 2010.
- Venture managers can still yield a successful fundraise by implementing a number of strategies to build new relationships and present an attractive investment opportunity.

The alternative investment market has been subject to severe strain over the last 18 months as the global recession has affected both investment returns and fundraising. Venture capital has not escaped unscathed. More importantly, the venture capital market is seeing the culmination of a number of secular trends that are challenging limited partners' commitment to this sector. While fund managers in a number of private equity sectors such as middle-market buyouts and growth capital are anticipating a rebound in investor interest and fundraising in 2010 with the change in the economic cycle, venture capitalists will likely face a more challenging environment that will impact their capital-raising plans. Fund managers should be prepared for these challenges and may benefit from certain strategies to attract investor capital.

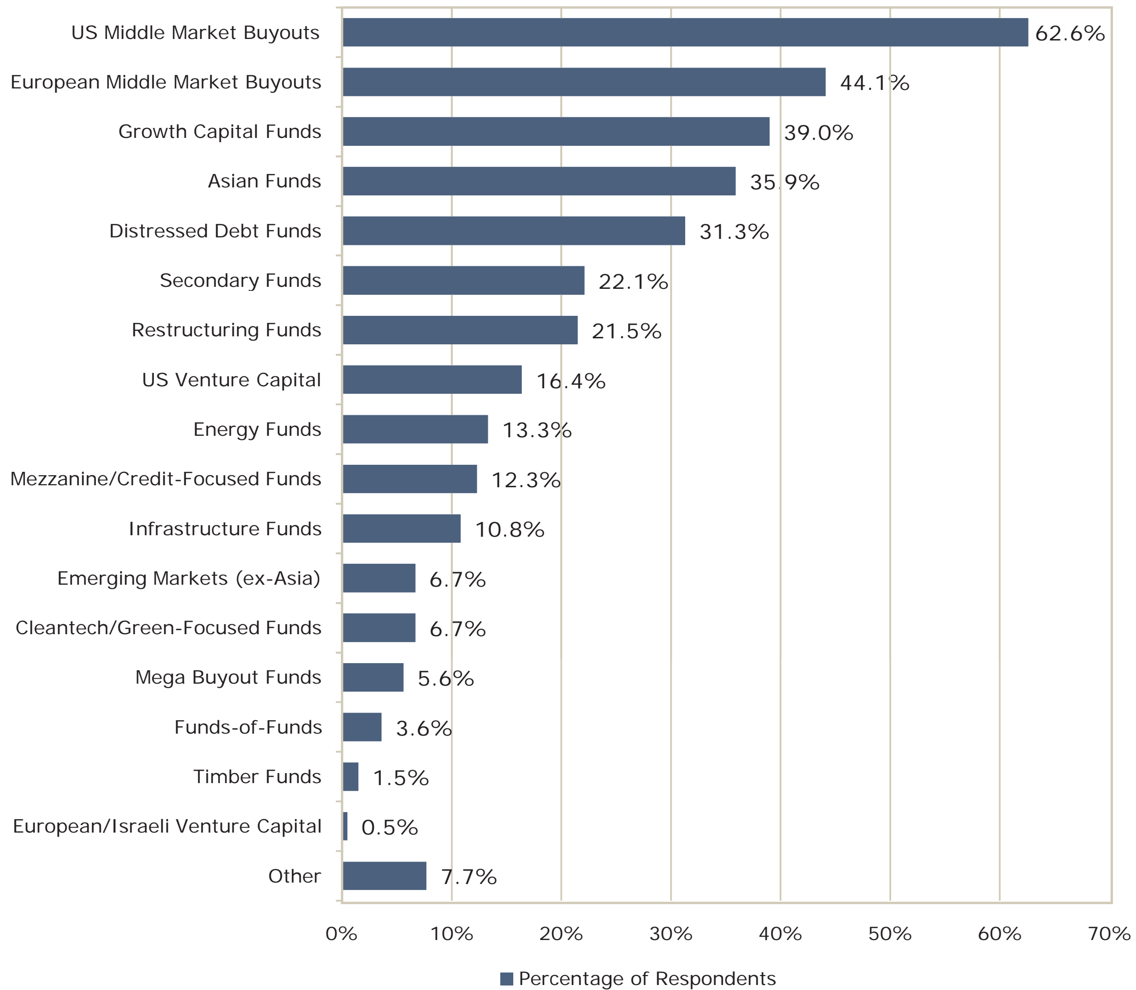
Comparative Investor Interest

Probitas Partners oversees an annual survey of institutional investors on their attitudes towards private equity, tracking responses from over 275 North American, European and Asian investors. Chart I details the responses of investors in the latest survey, which was completed in November 2009, looking towards investors' plans for 2010. US venture capital ranked only 8th in the survey among the options, with cleantech/green-focused funds (many of which are venture vehicles) ranking 13th and European/Israeli venture capital ranking 17th and last among the pre-set options. Interest in venture capital is strongest among North American investors, and relatively weak among European and Asian respondents. Notably,

Chart I

2010 Key Areas of Interest

"During 2010, I plan to focus most of my attention on investing in the following sectors... (choose no more than four)"



Source: Probitas Partners 2010 Private Equity Institutional Investor Survey

Table I: Percentage of Survey Respondents Targeting Venture Capital & Comparative Ranking Versus Other Sectors of Private Equity

		2007	2008	2009	2010
US Venture Capital	% of Respondents	34.1%	28.8%	12.6%	16.0%
	Category Rank	3rd	4th	8th	8th
European Venture Capital	% of Respondents	4.7%	5.3%	1.9%	0.5%
	Category Rank	Last	Last	Last	Last

Source: Probitas Partners 2010 Private Equity Institutional Investor Survey

Table II: US Venture Capital Index Returns

For the Period Ending	Quarter	1 Year	3 Year	5 Year	10 Year	15 Year	20 Year
September 30, 2009	2.3	-12.4	1.3	4.9	8.4	36.6	23.1
June 30, 2009	0.2	-17.1	1.3	5.7	14.3	36.3	22.7
September 30, 2008	-2.9	-0.9	10.2	10.7	40.2	33.3	22.2

Source: NVCA/Cambridge Associates

European venture capital placed last even among European investors, further indicating weak interest levels in that specific sector.

The low ranking of venture capital in 2010 investor interest does not appear to be the result of a sudden change brought on by the latest market cycle. Table I highlights the rankings for US and European venture capital over the last four annual surveys. In 2007, US venture capital was ranked 3rd in overall investor interest and was one of the core sectors of private equity interest for many investors. Since then, interest in US venture capital has fallen fairly consistently over the period. Interest in European venture capital has never been strong in our surveys, but it managed to reach a new low in 2010, with only 0.5% of respondents saying that they were focused on the sector.

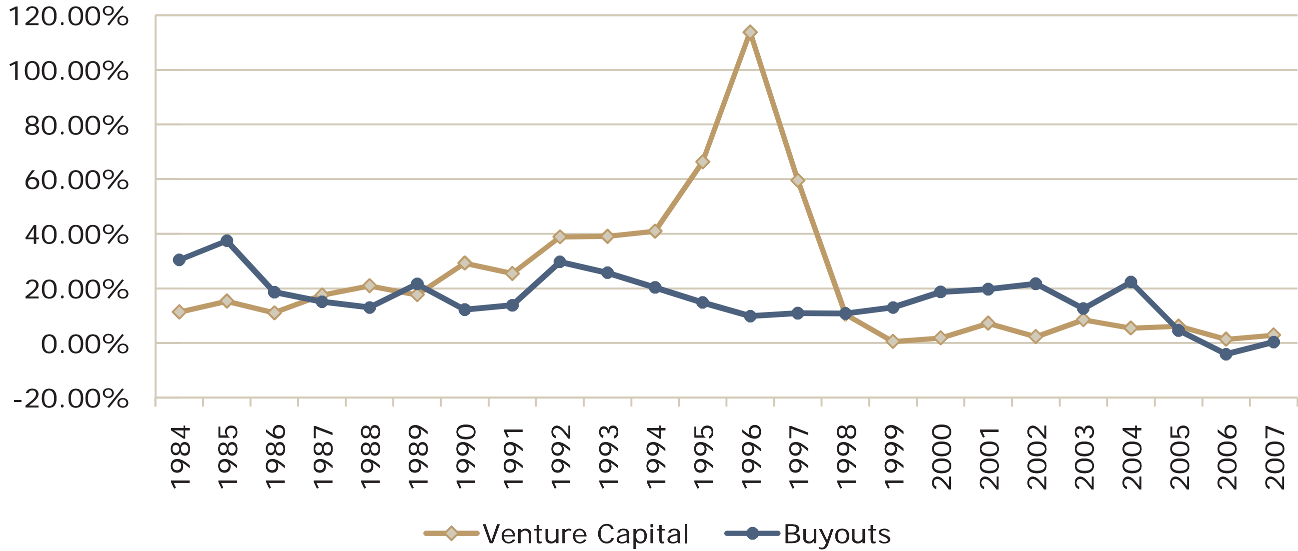
In Probitas Partners' individual conversations with limited partners over the last four years, the tenor of comments regarding venture capital has become increasingly negative. Complaints range from "the venture model is broken" to "why is it taking so long to find the next new thing" to "when am I going to get distributions." However, the most frequent criticism recently has been, "I have been investing in the sector for almost 10 years and I haven't made any money — why should I keep investing in VC."

This last complaint was highlighted in an analysis done for the National Venture Capital Association (NVCA) in late 2009 by Cambridge Associates, with the key data displayed in Table II. The 10-year horizon return data for US venture capital (the strongest and deepest sector in the venture market, and the one the rest of this review will focus on) has begun to decline dramatically as the high returns of the late 1990s roll out of that index. While recent weak returns affected by the general market downturn over the last 18 months have not helped, the earliest returns in any IRR calculation have the most significant impact on the calculation. As the strong returns of the late 1990s are eliminated from the data, the bleakness of the past decade as far as overall investor returns is becoming increasingly evident.

The returns of the last decade stand in stark contrast to the returns of the 1990s. As detailed in Chart II, top quartile vintage year returns for venture capital dominated returns in the buyout sector throughout most of the 1990s, reaching unprecedented levels for vintage 1995 through 1997 funds. Those soaring returns also attracted a wave of capital and new funds (see Chart III for details) that overwhelmed the sector. Subsequently, pricing discipline eroded as general partners competed to gain access to an Internet sector that seemed to only keep going up in value. The result was predictable – a collapse of returns and a dramatic fall in fundraising as the market sought equilibrium. Nearly 10 years on, top quartile IRRs for vintage 1999 funds are still less than 1%, while median returns are a negative 5.8%.

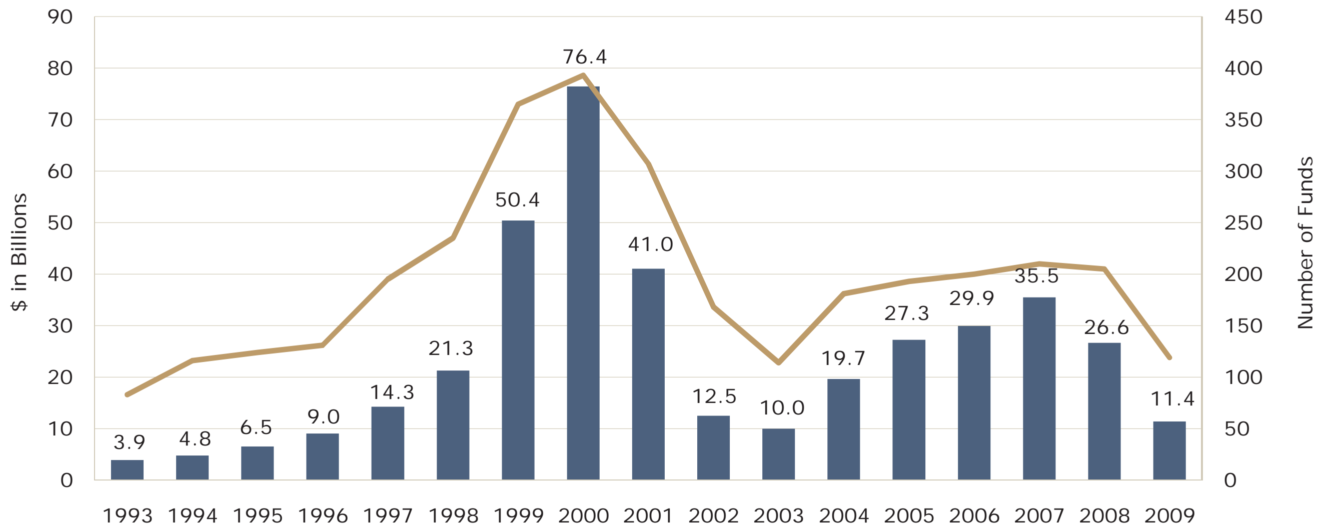
Chart II also shows that buyout funds, considered by many to be a laggard in the late 1990s, outperformed venture over the last 10 years. Although buyout returns have been negatively impacted by the latest market downturn, many institutional investors see the problem for buyouts, especially in the middle market, to be a cyclical and not a systemic issue driven by an oversupply of capital from 2004 through 2007 and accelerated by a dramatic recession. However, many investors seem to believe that the cycle has turned,

Chart II



Source: Thomson Venture Economics

Chart III



Source: Private Equity Analyst

and that now is the time to invest in order to generate superior returns.

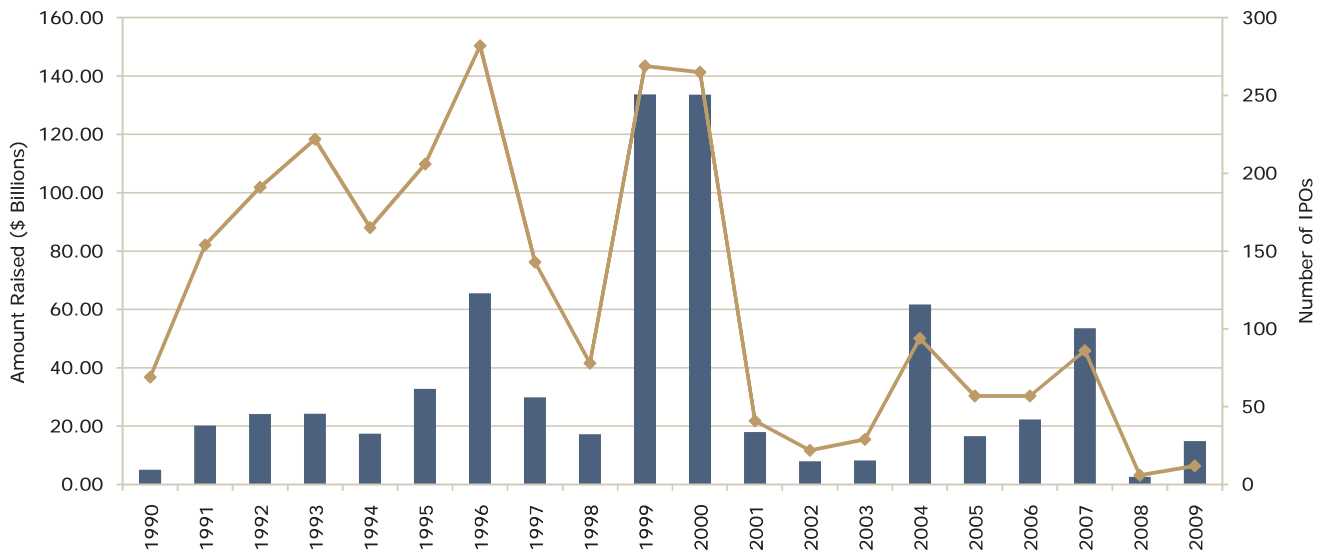
Institutional investor concerns over venture capital, however, are not just focused on comparative opportunities within the private equity universe or short-term cyclical shifts. Chart II also tracks top quartile returns through vintage year 2007, the latest year in which returns have some degree of meaning. From vintage 1999 through 2007, top quartile returns were roughly equal to high-quality corporate bonds. Median returns, however, were much worse, with only vintage year 2003 showing positive median returns to date, at 2.9%.

Long-Term Secular Issues

In light of this weak performance, many investors are beginning to question whether venture capital remains a viable sector of the private equity market worthy of strong focus, as opposed to a niche market with occasional opportunities. They are concerned that there are a number of key issues unlikely to improve in the near term that are dragging the sector down.

- **Lack of a deep IPO market for venture-backed companies:** In the past, the IPO market has served as an important source of outsized returns that made venture capital an attractive investment at the fund level. Chart IV tracks the market for venture-backed IPOs over the last 20 years. The market peaked in 1999 and 2000, in terms of both dollars raised and number of IPOs, but has since been quiet, with both metrics falling significantly. When the Internet bubble burst, investors expected the market to rebound after its correction, but that has not been the case. Most of the boutique investment banks that focused on venture capital in the 1980s and 1990s were acquired by larger institutions in the boom market, and their successors have shifted to focus on larger opportunities. Even the two most recent years where the dollar volume of IPOs spiked were aberrations, with Google's IPO making up 37% of the 2004 total (and SMIC, a Chinese semiconductor manufacturer, raising a further 11%) and MetroPCS comprising 15% of the 2007 total (with China Nepstar raising a further 6%). The lack of a deep IPO market has negatively impacted one of the most important channels used by venture capital firms to generate superior investment performance.
- **While M&A exit activity has increased, its returns are less profitable:** Chart V shows that as IPO activity has decreased, M&A activity as a method of exit has increased. Though certainly an important means of exit, it is often less lucrative with a lower multiple of return for venture investors, making it difficult for venture capitalists to generate adequate "outsized returns" to compensate for the investment losses that typically occur in a venture portfolio.
- **Venture investments in new firms have outpaced the ability to exit current holdings:** Though M&A activity has taken up some of the slack of the IPO market decline, M&A and IPOs combined have not kept pace with new investments. Holding periods for venture-backed portfolio companies have extended considerably, with the median time to IPO increasing from 3 years in 2000 to nearly 8 years in 2009, and the median time to an M&A exit increasing from approximately 2.5 years in 2000 to 5 years in 2009. These delays have negatively affected IRRs and distributions to limited partners that could be recycled into new commitments.
- **Lack of a transformative investment opportunity:** In the late 1980s, the personal computer and related products became a catalyst for the venture capital market, capturing both private market and public market attention. In the 1990s, the Internet (from web-based products and delivery to the build-out of the telecommunications backbone of the Net) played a similar role in driving new investments and superior returns. The last 10 years have not seen a comparable opportunity that has transformed the investment market. While there has been talk at various points about nanotechnology or cleantech being "the Next New Thing," clear success is still over the horizon.
- **Continued oversupply of capital and VC firms:** Many investors feel that there are still too many venture capital funds in the market with too much capital to invest. Though the number of funds and capital in the market since the 1999 to 2001 peak (see Chart III for details) has declined, the industry has not returned to what was a much smaller, niche market in the early and mid-1990s (notwithstanding that nearly 25% of the funds that raised their first vehicle in the 1999 to 2001 period have failed to raise a follow-on fund). Some institutional investors

Chart IV



Source: Thomson Venture Economics

feel that, on a steady-state basis, the US venture capital market should be raising only $10 billion to $15 billion a year.

For all of the reasons above, there is a growing sentiment among investors that only the "Top 10" or "Top 25" venture capital firms are worthy of investment, though agreement on exactly which firms fall into those categories is open to debate. Still, the fundraising market maintains clear distinctions between a very small group of "must haves" that tend to raise money in weeks or a few months, and a much larger group of funds that take many months or years to raise capital — or increasingly, fail to raise capital at all.

Recent Fundraising Market

In addition to larger secular issues within the industry, venture capital firms have suffered further setbacks due to the global recession. This downturn had a profound global impact on institutional investors, including those active in venture capital investing, and caused overallocation and liquidity issues for many limited partners. Reeling from the now well-documented "Denominator Effect," a number of investors could not add new commitments to their portfolios, and many sought relief from this imbalance. Additionally, a number of investors faced significant liquidity pressures as the complexion of their portfolios changed and their cash demands remained constant or increased.

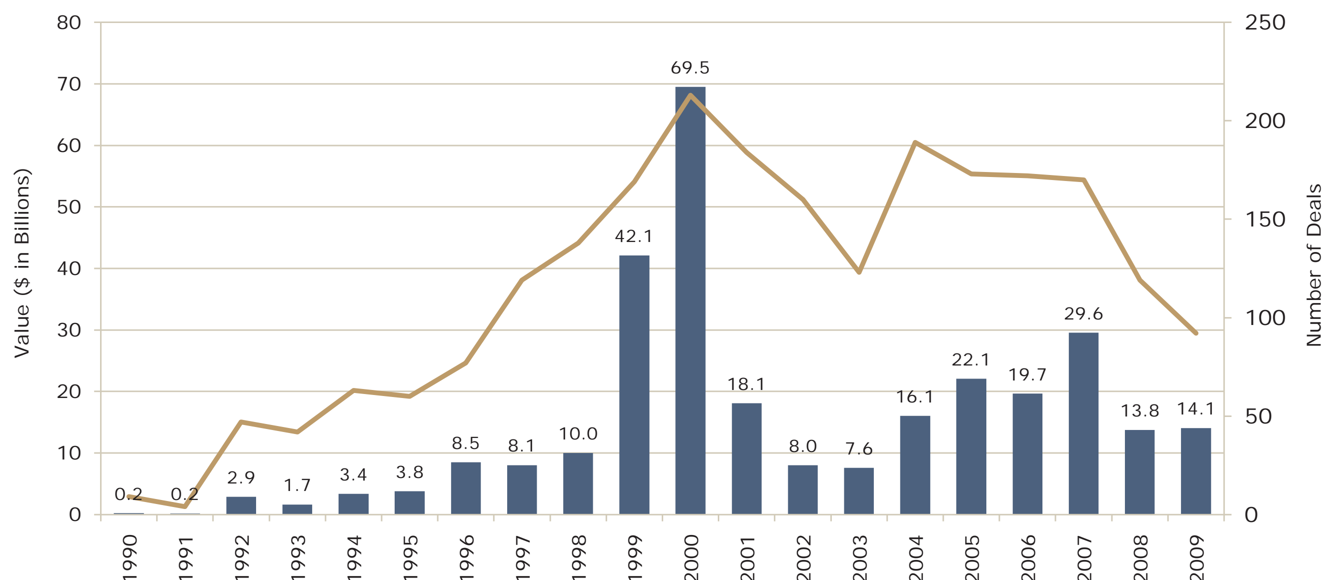
As a result of these factors, the venture capital market (like the rest of the private equity market) experienced the following trends in 2009:

Limited new commitments – Investors had limited available capital, if any, for new fund commitments, and many investors with available capital began focusing solely on reinvesting with their core relationships as well as seeking new relationships which had previously been difficult to access.

Delayed fundraising – With uncertainty in the market and distractions caused by portfolio company challenges, many general partners delayed their plans to fundraise in 2009. A number were concerned about the response they would receive, while others had to attend to portfolio issues in the face of an uncertain market. Two results of this development are that (i) the options for primary fund commitments available to investors became more limited in 2009, and (ii) partly as a result of that delay, an overwhelming number of fund managers are expected to fundraise in 2010.

Selling assets on the secondary market – A number of investors sought to address their allocation or liquidity issues by selling assets on the secondary

Chart V



Source: NVCA/Thomson Reuters

Note: Transactions with announced valuations in the M&A market are roughly 50% of volume by number of deals; most of the M&A transactions without announced values are smaller deals.

market. Their goal was either to rebalance their overall investment portfolios and/or to raise capital to fund short-term requirements. As has been widely publicized, executing transactions in the secondary market became a challenge as a wide bid/ask spread dominated through much of 2009. As a result, many investors were unable to achieve the relief they were seeking, keeping capital locked in the hands of those same investors and unavailable for commitment to new investment vehicles.

Buying assets on the secondary market — A somewhat unforeseen impact of the economic downturn on the fundraising market was the cannibalization of the primary fundraising market by the secondary market. An increasing number of traditional investors in private equity and venture capital began to seek opportunities on the secondary market in order to (i) build new relationships, (ii) increase exposure to existing relationships, (iii) seek good-valued, opportunistic investments, or (iv) construct new alternative asset portfolios with a shorter J-curve effect. As a result, while less fund managers were out raising a new investment vehicle, investors had numerous competing options for their capital with the broadening of the secondary market.

Long-term secular challenges, coupled with the added pressure of recent macroeconomic trends, made for an especially challenging fundraising market in 2009. The fundraising time frame stretched from an average of 12 to 18 months to 18 to 24 months. Competition was fierce — only 119 US venture capital funds successfully raised money last year, compared to 205 in 2008. These fund managers raised just $11.4 billion in capital, down 57% from the $26.6 billion total for 2008, according to Private Equity Analyst. In 2009, many general partners failed to secure their expected targets or halted fundraising completely, while others postponed fundraising, hoping to restart the process when economic conditions improve.

Fundraising in the Current Environment

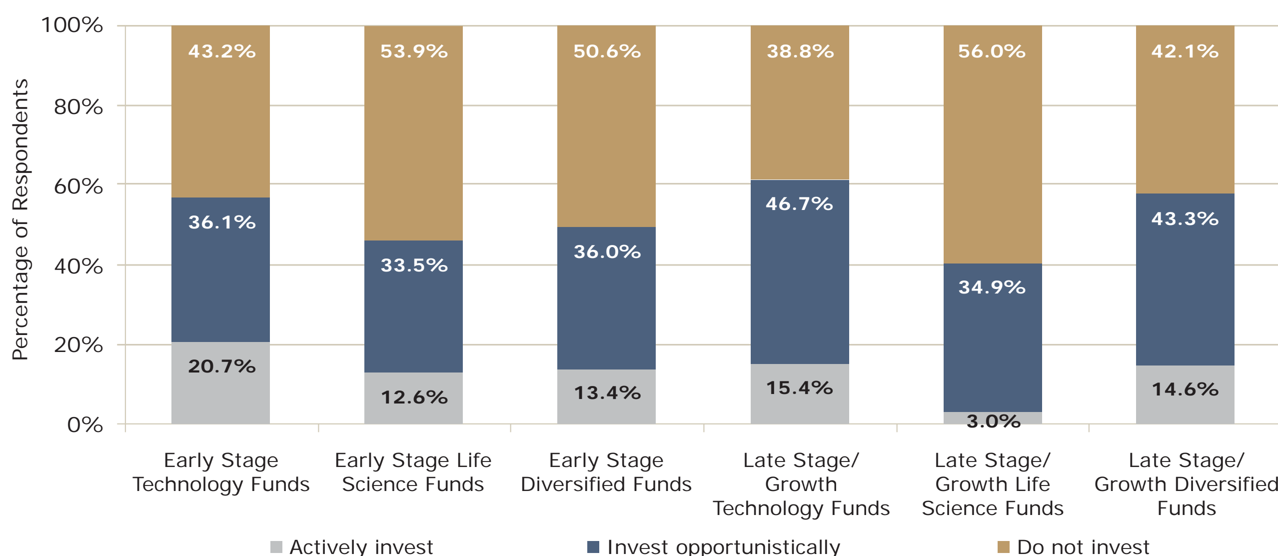
A fund manager bringing a new vehicle to market must believe in his fund's value proposition or there would be no reason to proceed. However, unless a manager is one of the few favored "must haves," he must be prepared for the degree of skepticism which he is likely to encounter, not only on his fund in particular but the sector in general.

So what are institutional investors looking for in venture capital?

- **A strong track record of realized returns:** Many investors have spent too much time over the last several years listening to presentations about specific sectors or current portfolio companies that promise to drive future returns, and more often than not, these investments have failed to do so. As such, investors are keenly focused on those fund managers with a demonstrated history of generating superior returns – more so if those returns were generated in the last 10 years as opposed to the mid-1990s.
- **The commitment of a strong, cohesive and relevant team:** Many venture capital groups have contracted over the last 10 years while others have faced substantial succession issues. Institutional investors are strongly focused on senior turnover, not because all turnover is necessarily bad, but because it could indicate future fund instability. Fund managers must manage turnover in a forthright manner or risk potential investors quickly moving on to the next opportunity. Moreover, investors want to see an economic alignment to ensure cohesiveness and teamwork throughout the organization. Additionally, the team must demonstrate experience that is relevant to the track record presented. If a track record is entirely driven by mid-1990s transactions that were led by partners no longer with the firm, that track record will likely be viewed as irrelevant in helping to determine the prospects of the fund currently being raised.
- **A clear, differentiated value proposition:** Though investors are focused on a successful history, they also want to know how a fund manager intends to create value in the future. Most important is how the firm differentiates itself from its competitors and how it plans to deliver attractive returns within the current environment.
- **The "cleantech" conundrum:** There is one area of venture capital that is somewhat set apart – cleantech. Though interest in the sector as a "pure play" is somewhat lower than for venture overall (see Chart I), there are a few institutional investors who, for strategic reasons, have established specific allocations for this sub-sector. However, there are few fund managers with a deep history and track record in cleantech and there have been very few large exits to date.

Referring back to the Probitas Partners Annual Investor Survey, following is an illustration of the sectors that investors are most interested in investing in.

Chart IV



Venture capital firms need to prepare themselves adequately for the challenges of the current fundraising environment. The following is a list of helpful hints for fundraising in today's market:

- **Maintain strong investor relationships:** A critical step in fundraising is to establish the support of existing limited partners prior to launching a new fundraise. Additionally, prior to formally starting a fundraise, managers should begin to build new relationships with prospective investors. One could say a venture capital firm is always in fundraising. While these endeavors require a commitment of time and resources, their importance to a successful fundraise cannot be overstated. These established and early-moving relationships will hopefully deliver fundraising momentum, which is mission-critical to success. Managers should always bear in mind that personal relationships with limited partners matter, and traits like transparency, consistency and high ethical standards build the trust that limited partners need to have in managers with whom they invest.
- **Differentiate yourself:** It is important to differentiate your firm from other venture capital firms. Unlike 15 years ago, when a number of investors were in the early stages of constructing their venture capital portfolios, many now have a diverse group of firms with whom they invest. A venture manager coming to market must be able to complement a limited partner's existing portfolio, whether by covering new markets, utilizing a new approach or investing with a unique perspective. At the same time, successful firms should not portray themselves as so different to the point that their strategy, process, or team becomes difficult for investors to evaluate or appears too risky. Funds can effectively differentiate themselves by identifying and highlighting their key competitive advantages, whether that be sector focus, team attributes, or unique networks.
- **Be prepared before you go to market:** Firms should set the same expectation for themselves as they would a management team with whom they are meeting – be prepared. A marketing presentation should be rehearsed and presented in an honest, clear, concise and organized fashion. Importantly, fund managers should be prepared up front concerning what information they are willing and not willing to provide to prospective limited partners, recognizing that thorough diligence is a key element of most investors' investment processes. These diligence materials should be prepared and provided quickly after meetings and in a form that is easily understood. Importantly, one should see the exchanging of diligence information as another opportunity to connect and build a relationship with a potential investor.
- **Maintain consistent follow-up:** After meetings, fund managers should strive to be persistent about follow-up but not bothersome. Knowing when to sit back is critical and, at some point, "no means no." In these situations, firms should try to get candid feedback to ensure they can be prepared to address similar issues with other investors going forward.

Conclusion

The venture capital market is suffering from long-term secular issues which are affecting its profitability as an investment sector. A number of institutional partners that have been active in the sector have begun to lose faith in the market as a primary sector of interest and, as a result, are limiting new commitments and trimming past relationships. Furthermore, recent challenges within the broader global economy have further impacted the venture capital fundraising market. Venture capital fund managers coming to market must be aware of institutional investor issues and concerns, and must be prepared to address those concerns as well as highlight their strengths in order to achieve a successful fundraise.

About the Author

Craig Marmer *has 16 years of industry experience and is responsible for Probitas Partners' primary fundraising project management activities as well as leading its secondary practice. Prior to founding Probitas Partners, Craig served as a Vice President at Credit Suisse First Boston (formerly Donaldson, Lufkin & Jenrette) in the Private Fund Group.*

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