Venture capital's new golden age

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By John Backus and Todd Hixon, contributors
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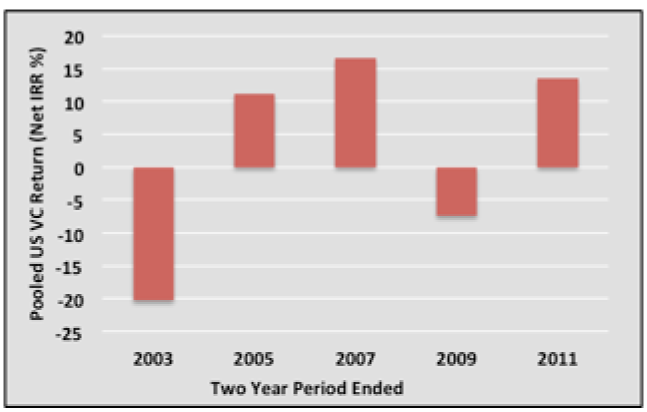
Don't believe the negativity -- venture capital is just hitting its stride.

The venture capital model is dead, proclaimed the Kauffman Foundation recently. Too much available money for the VC model to succeed added Union Square's Fred Wilson. Another details 25+ stories on why the VC model is broken. Sevin Rosen, a firm known for PC and telecom hardware investments in the 1990s, started this death watch in 2006, when it aborted closing a new fund.

Average VC returns for the last ten years do stink. Cambridge Associates made headlines when its 10-year cumulative U.S. VC return index went negative at (2.0%)/year in December 2010. The index popped up to 3.3%/year for the decade through December 2011. Over the same period the NASDAQ returned 2.9%/year. But, given the illiquid nature of VC investments, investors deserve a 3% - 5% premium, at least, over public markets.

First, a bit of perspective: These are rear-view-mirror analyses, informative but not predictive. In the '98-'00 burst of "irrational exuberance," over $200 billion of capital flooded into the U.S. venture market, which had previously absorbed $5-$10 billion per year. This money put a huge supply overhang on the market that has taken time to disappear.

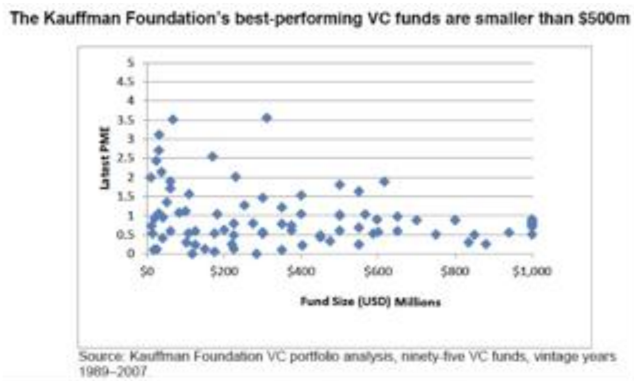


Cambridge Associates, U.S. VC Fund Index

As the chart above shows, over-supply of capital caused returns to plummet in 2002 and 2003. These two years of -20% returns are the main driver of poor returns for the decade. The other downward blip was the global financial crisis, which the VC community weathered easily (no systemic risk here!). For the rest of the decade, VC produced solid returns of 11%-17% net to investors. This is not yet stellar, but it is 4%-10% above the ~7% return most investors expect from public equity markets. And these are average returns; certain funds do much better.

A key lesson learned (or re-learned) from'98-'00 is: Venture fund returns are higher if the fund size is between $100 and $400 million. The big influx of capital created many $1 billion venture funds. They have not delivered big returns. As Harvard Business School's Josh Lerner wrote in a recent paper: "We find that LPs that have higher average IRRs also tend to invest in smaller and slower growing funds …"

Silicon Valley Bank analyzed the "small is better" phenomenon in 2009 and concluded that smaller funds are five times more likely to deliver a "venture return" (2X+ net to investors) compared to on larger funds. The Kauffman Foundation confirmed SVB's finding with this analysis of its venture fund portfolio:



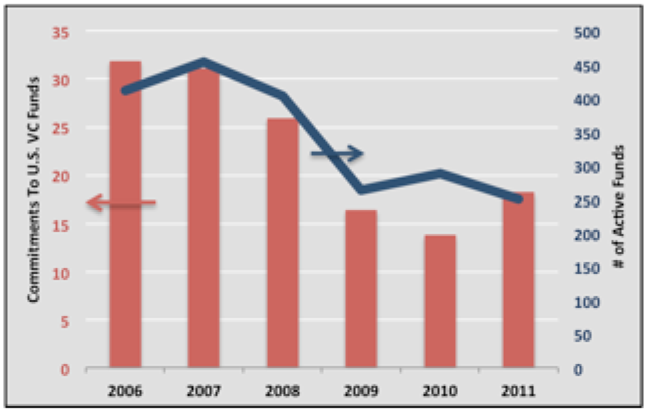
Looking forward, we see five converging forces that will strengthen the venture capital ecosystem:

1. **Disruption:** Social/local/mobile/web 2.0 is the greatest engine for disruption and innovation man has yet seen
2. **Entrepreneurs:** There has never been more energy for creating businesses
3. **Angels:** Seed funding by angels has bloomed and will grow further
4. **Reduced Supply** of venture capital
5. **Exits** are way up, and the road is paved for growth

Disruption. Mobile, social networks, the cloud, and the "digital native" generation are changing everything. They are already growing faster, and will be much bigger than the PC wave. Hard goods retailing and media (movies, books, and music) have already been uprooted by this tsunami. Local commerce feels the storm rising now. Healthcare and education don't believe it will hit them – just wait. Trillions of dollars of existing market value will be destroyed, and the disruptors will create even more value.

2. Entrepreneurs. One of our sons is going to college next year and wants to be a technology entrepreneur. That was not a mainstream choice when we went to college. But today's role models are on IPO road shows dressed in hoodies, student-entrepreneurs have cred and technology platform companies like Facebook have dramatically lowered the hurdle for software-based businesses.

3. Angels Take Flight. In 2010, angels invested $20.1 billion into 61,900 companies. When the crowdfunding provision of the JOBS Act goes live in January 2013, we think that number will grow dramatically – into the hundreds of thousands. The crowdfunding bill limits annual fundraising per company from the "crowd" to $1 million. That's enough money to prototype a company, but not enough to commercialize or scale it. There will be huge opportunity for VCs to carry the best companies and entrepreneurs forward.



Data via SVB Analytics & Dow Jones VentureSource

4. Reduced Supply Of Venture Capital. In contrast to the bountiful angels, the sources of venture capital are drying up. Both the dollars committed to VC funds and the number of active funds has declined by half in the last five years (chart above). In 2010 1,001 companies received initial funding from VC funds. This means that only ~2% of the 61,900 angel funded companies are likely to receive institutional venture capital. And crowdfunding will expand the pool of pre-VC companies. Early-stage VCs will see a huge flow of opportunities, many of them high-quality (i.e., companies that have prototypes and meaningful market results when we meet them). That's a very good thing for the early stage VCs that remain active.

5. More and Better Exits. The big breakthrough with the JOBS act is the "IPO On-Ramp", which reduces cost and delay for smaller companies aiming to go public and makes analyst coverage of small-cap companies attractive. The benefit of these changes will emerge over the next five years, as a new generation of boutique investment banks, like Alex Brown and Robertson Stephens, grows up to serve smaller start-up companies that are largely ignored by the "too big to fail" banks.

Finally, timing seems to be on the side of a new golden age of VC. You can't really time the venture market, because it takes too long to move in and out. But, fund investors can take confidence from the strong fundamentals noted above. Harbourvest founder Brooks Zug and Accel founder Arthur Patterson have both observed a long-term cycle in VC fund performance, and they both see the VC tide rising over the next five years. We're coming off a period of retrenchment in U.S. VC following the late '90s boom and the early '00s bust. Now is the time to take a new look at venture capital.