

# The Case for Venture Capital

Venture Capital Update

OCTOBER 2007

WRITTEN BY:

**Aaron Gershenberg**  
Managing Partner  
650.855.3011  
[agershenberg@svb.com](mailto:agershenberg@svb.com)

**Bronwyn Dylla**  
Research Director  
650.855.3021  
[bdylla@svb.com](mailto:bdylla@svb.com)

*“Too much money, too few good companies...”*

*“The backlog of companies is too large and most will never find meaningful exits...”*

*“Venture will provide poor returns”*

The doomsday scenarios are popping up on blogs and newsletters, at conferences, and even on the pages of the popular press. Some blame a perceived glut of companies or capital and others predict venture capital will never again reach historical performance levels after the Internet boom. Some might have predicted the same after the PC boom, but they would have been wrong.

Have we reached the end of an era? Not likely. The entire investment

community is still feeling the aftereffects of a major boom and bust cycle — one in which venture capital firms played a pivotal role. Sure, capital requirements are changing, alternative sources of funding have entered the mix, and successful exits with high multiples are more difficult to achieve, but VCs

Like business itself, venture capital's role is cyclical, and returns are best measured over the long term.

aren't going away anytime soon. They are simply adapting as market conditions change. Like business itself,

View the [Second Quarter 2007 U.S. Private Equity Snapshot](#) >>

venture capital's role is cyclical, and returns are best measured over the long term.

In this issue of the *Venture Capital Update*, SVB Capital weighs these negative perceptions of venture capital against quantitative evidence. Our findings offer insight into the future of venture capital, based on our view of the private equity market and what VCs themselves have told us. First, let us look at the data:

*“Too much money, too few good companies”*

Many industry participants and watchers continue to argue that the

too few deals, leading to diluted returns for investors and mediocre performance by the industry. Unlike in 2003 and 2004 when fundraising continued to increase while investment levels lagged, this trend now appears to have reversed. In the first half of 2007, the level of fundraising stagnated whereas investments in venture-backed companies continued to increase.

*“The backlog of companies is too large and most will never find meaningful exits”*

In conjunction with this argument, many in the industry have decried the backlog of venture-backed portfolio companies. According to Dow Jones Venture Source, more than 5,500 venture-backed companies are currently maturing toward exits either through a public offering or acquisition. While the exit market has improved after the dearth of initial public offerings (IPOs) between 2002 and 2004, only about 460 venture-backed companies exited in 2006 and just over 100 exited during the first half of 2007, according to Venture Source.<sup>1</sup>

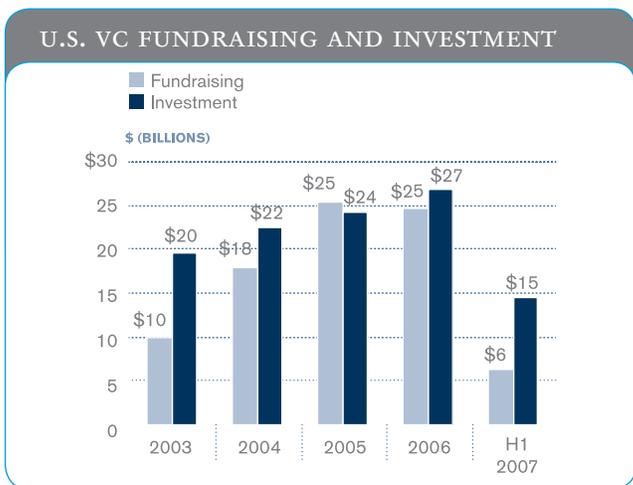
Given this annual exit rate, it would take almost 12 years for these companies to exit, if they exit at all.<sup>2</sup> The apparent

result? Mediocre returns for investors. A closer look at the backlog reveals that a large proportion of these companies were funded during the bubble years of 1999 and 2000. More than 30 percent of maturing venture-backed companies received their first funding in 2001 or earlier. Since the median number of years from first funding to exit is about six years,<sup>3</sup> we would expect half of all exits in 2007 to come from companies receiving funding before 2002. Many of these

Once the one-time bubble backlog is cleared, those looking to exit will stand a better chance for more attractive returns.

companies are being nurtured by investors in order to exit at higher valuations. Moreover, many of these companies have been recapitalized or restructured with investors maintaining significant ownership stakes and expecting attractive returns.

At the opposite end of the pipeline lie approximately 30 percent of companies that received first financings in 2005



Source: Dow Jones Venture Source

funds being raised by VCs are too large relative to the limited number of good investment opportunities. The result, they argue, is that there is still too much money chasing

and 2006. These newly venture-backed companies will take some time to mature and exit. Once the one-time bubble backlog is cleared, the remaining companies will have a more even annual distribution and those looking to exit will stand a better chance for more attractive returns. At that time, it is possible that the ratio of exits to the pipeline of companies will return to historical levels. Assuming that the exit market continues to improve, fund performance levels should also return to the prior trend.

*“Venture provides poor returns”*

Certain recent industry reports offer our viewpoints from those watching the venture market. For example, one recent report argued that venture funds have performed worse than savings accounts in recent years.<sup>4</sup> The article cited Thomson Financial data on internal rates of return (IRRs) for the five years ending in the first quarter 2007 for funds raised between 2001 and 2007. According to the article, these funds have a median IRR of -2.6 percent and the upper quartile benchmark was at just 4.1 percent. The article states, “The data beginning in vintage year 2003 is even worse... The median for these funds is -5.7 percent, with the upper quartile benchmark at -0.2 percent.”

There is no doubt that the Internet crash affected the venture market and that

its impact is still visible in returns today; however, the article’s methodology of looking at the median of a collection of funds from vintage years 2001 to 2007 produces biased results for two reasons. First, this sample lumps funds with arguably one of the worst performing vintage years (2001). Given that an unusually large number of funds came to market in 2001, the combination of numerous funds with low performance results skews the median of the sample downward. Second, the sample includes a large proportion of immature funds, i.e., funds less than four years old, which may still be under water due to the J-curve effect and which also skew the median of the sample.<sup>5</sup>

A better estimate of venture performance pools cash flows from

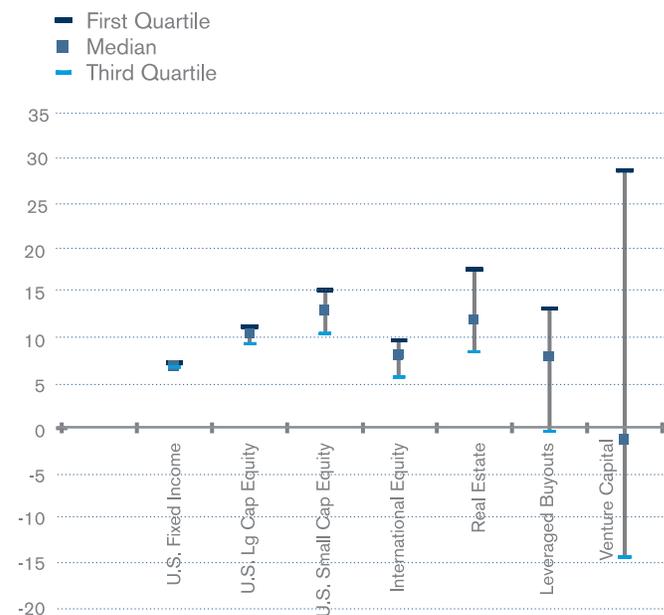
POOLED IRR % BY INVESTMENT TYPE

Fund Type	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr
Early Stage	8.00	7.20	-1.30	40.00	21.50
Late Stage	23.50	9.60	5.20	10.00	13.80
All Venture	18.10	9.60	2.70	21.00	16.40
All Buyouts	22.30	15.00	11.40	8.90	13.10

Source: Thomson Financial, performance as of March 31, 2007

all funds in operation during a given period of time. This metric weights performance by dollars and reduces the J-curve effect since it includes more mature funds as well as funds from recent vintage years. The five-year result for pooled IRRs is low at only

DISPERSION OF ACTIVE MANAGEMENT RETURNS



Source: Data from Russell/Mellon and Cambridge Associates found in the University of Washington “Investment Performance Report as of December 31, 2005.”

2.70 percent, but strong performance for one-year and three-year returns show signs that the market is coming back. While buyout performance has exceeded venture performance in the past five years — in part due to cheap credit previously available to buyout shops — venture outperforms buyouts during the 10-year and 20-year periods. Since venture funds take eight to ten years to mature, the measures of long-term performance are the most meaningful gauges of venture performance.

#### WHERE IS VENTURE CAPITAL HEADED?

Examining recent data helps provide a balanced assessment of the current state of the venture market, but what's next for the VC industry? Three trends offer reasons to be optimistic:

1. *Upper quartile returns remain robust*
2. *The exit market has improved*
3. *Innovation continues to drive value creation*

#### 1. *Upper quartile returns remain robust*

Without a doubt, economic value is concentrated in the hands of the top venture firms, and venture investing is an access play. In a recent study, Focus Ventures found that during the venture boom of 1997 through 2000, the top 50 venture capital firms shared almost 70 percent of the total value created by venture-

**Economic value is concentrated in the hands of the top venture firms.**

backed IPOs during this period. Moreover, of the top 50 firms during the period of the Internet boom, 38 of these firms were also in the top 50 during the “PC boom” in the mid-1980s.<sup>6</sup>

Furthermore, these top funds make significantly higher returns than their counterparts. The chart below illustrates the difference between upper quartile venture funds and the median venture funds, and as compared to other asset classes. This differential is particularly stark when comparing venture fund performance to public fund performance. The large variation in performance between the upper quartile funds and the median funds remain true today. Based on data from Thomson Financial, the top quartile IRR of all venture funds as of March 31, 2007 equaled 15.5 percent, while the median was only 4.5 percent.

Upper quartile venture funds continue to show strong performance, but how can we be sure that it will persist? Research has shown that a correlation

exists between the performance of a fund management team during its first fund and the performance of the same team in follow-on funds. One study from *Private Equity International* found that 35 percent of fund managers with top quartile performance in their first fund will achieve top quartile performance with their second fund, and 40 percent of these fund managers will achieve top quartile performance in their third fund. Of these fund managers, 40 percent will return to top quartile performance in their fourth fund.<sup>7</sup> On the opposite end of the spectrum, the study showed that a first fund performing in the third or fourth quartile will most likely not raise a successor fund.

One factor contributing to the successful repeat performance of a fund is the power of its brand. Venture capitalists with strong brand power, driven by their ability to nurture companies to lucrative exits, will continue to be successful. Investors with brand clout maintain highly connected networks of talented entrepreneurs, CEOs, investment banks, strategic advisors and other key business operators to the benefit of their portfolio companies. In addition, these GPs tend to have access to the most promising companies. As a result, the most highly regarded brands, whether they're individuals or partnerships, generally maintain access to premier

One factor contributing to the successful repeat performance of a fund is the power of its brand.

deal flow and therefore continue to outperform their counterparts. It is also true that emerging managers can quickly create a positive brand for themselves by building strong, profitable companies.

## 2. The exit market has improved

The outlook for top quartile venture funds as well as their counterparts has recently improved, driven mainly by a stronger market for public offerings. There have been more IPOs and greater levels of capital raised at public offerings by venture-backed companies in the first half of 2007 than in any year since 2000.<sup>9</sup> One possible reason for the increase is that companies founded under Sarbanes-Oxley regulation benefit from having had time to anticipate the compliance requirements and have built in Sarbox processes from the earliest stages of development. Because these companies grew up under increased regulation, legal and financial advisors to these

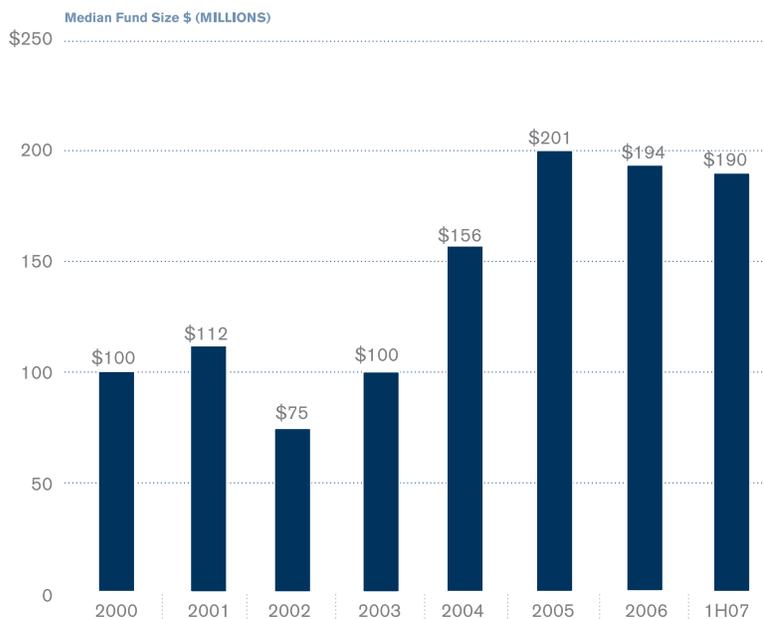
companies are better equipped to provide guidance and counsel without undue cost and delay. It's interesting to note that more than half of the current IPO exits and M&As come from "bubble survivors," i.e., companies that received their first financing rounds in 2001 or earlier.

Since the IPO market rebounded, venture-backed companies have been able to shoot for a strong public offering rather than settle for acquisition, the most common outcome. With an improved IPO market, entrepreneurs now have a viable alternative to M&A exits,

which allows them to resist the call of suitors, resulting in higher bids from potential acquirers. As one venture capitalist commented to us, "the IPO market will now keep M&As honest."

In addition to strong IPOs, companies with solid performance are maintaining their value after going public. Consider Infinera Corp. (INFN), an optical communications solutions company that raised \$182 million in its June 7, 2007 public offering and saw its share price climb from \$13 to over \$18 at the end of August. Even financial volatility is not preventing tech IPOs

MEDIAN VC FUND SIZE FOR FUNDS GREATER THAN \$20M



Source: Dow Jones, Venture Source

from gaining steam. VMWare's (VMW) initial public offering was priced on August 14, 2007 at \$29 and began trading on the secondary market on August 15, opening at more than double the offering price. VMW closed at just under \$70 per share by the end of the month. Moreover, the share price for Riverbed (RVBD), a company developing technology for wide area networks, began in September 2006 at about \$15 and has remained above \$40 since June 2007. Rising stock prices of high performing tech companies show their strength as well as the market's eagerness to invest in robust public technology firms.<sup>10</sup>

Although the overall future of the industry looks bright, certain funds will suffer as the market evolves. A number of industry observers predict an upcoming "shakeout" of venture firms. Indeed, evidence of consolidation has already appeared; some funds are unable to raise a follow-on fund, while others are closing their doors completely. In addition, the median fund size has begun to level off. Implicit in this notion of consolidation is the inevitable — that venture firms left standing will be that much stronger and will show improved returns as a result of reduced competition for deal flow. We also observe venture firms adapting their strategies to the changing climate. Such examples include switching to a "dual track"

approach with distinct early stage and late stage investment teams adjusting their sector focus, and looking abroad for investment opportunities in regions such as China, India and Israel.

### *3. Innovation continues to drive value creation*

Technological innovation drives venture returns. During the mid-1980s,

A number of industry observers predict an upcoming "shakeout" of venture firms.

innovations in the personal computer created markets for hardware and software that consumers used in the office and at home. During the late 1990s, the communication and Internet boom changed the way we access information as well as entertainment. Today, many venture capitalists point to innovations around anytime, anywhere access of the Web and higher bandwidth, which will increasingly facilitate commerce and information exchange. Even as some parts of the technology industry have become commoditized, a new cycle of innovation is underway. In 2006 the

number of design patents granted by the U.S. Patent and Trademark Office topped all preceding years since 1993 at 11,691 patents.<sup>11</sup>

What's more, the information technology market is larger than it was even five years ago and continues to expand. IDC estimates that information technology spending in the U.S. alone — excluding spending on technology in developing economies — will increase from \$439 billion in 2006 to almost \$543 billion by 2010, with packaged software leading the growth at an annual rate of eight percent.<sup>12</sup> Part of the rise in technology spending will be created by purchases from companies with innovations that improve computing performance, such as VMWare, or data transmission efficiency, such as Riverbed. Other opportunities in the expanded market include companies that seek to ride the wave of "convergence" of delivery methods for consumer content. Companies such as MobiTV and Joost bring television to mobile devices and piggyback on the high penetration of these devices. According to IDC, the worldwide market for mobile devices that can receive content, such as cell phones and PDAs, topped 80.5 million in 2006 and will grow to 304 million by 2011.<sup>13</sup>

Enterprise IT needs continue to grow as well. One survey showed that 40

Entrepreneurs that fuel the important companies of tomorrow will always need venture capital and the quality professionals who provide it.

percent of CIOs named “beefing up IT security” and 30 percent named “server consolidation” as their spending priority in the next 12 months.<sup>14</sup> At the same time, trends such as social media, user-generated content, open source development and Internet-hosted applications are gaining traction in the workplace and driving greater efficiencies. “The Oracle and SAP model of integrating software across the enterprise is dead,” said one VC. “Internet-based services will dominate the next era of enterprise computing.”

Demand for improved healthcare has also driven technological innovation. The aging of the baby boom generation and increased life expectancy has created the need for better remedies for chronic illnesses, such as cardiovascular disease and diabetes. New developments in

nanotechnology are also expected to lead to more targeted treatments for cancer and improved diagnoses of infection.

#### THE CYCLE BEGINS ANEW

The trends outlined above are among the reasons we believe there is more cause for optimism than alarm in the venture market over the next several years. True, the end of the PC boom took the wind out of venture capital’s sails before the Internet explosion brought an abundance of new investors to the asset class. Some of these investors have moved on to other alternative investment types after the dotcom crash delivered disappointing returns. Nonetheless, many indicators point to venture’s climb from the trough to begin a new cycle of investment in innovation. Using a popular metaphor, one VC told us, “Investors are putting more money in other assets... however, it is better to skate to where the hockey puck is going instead of where it was.”

No one would argue that venture capital is the asset class for all investor types, but the model of smart investors finding driven entrepreneurs has been proven successful many times over. Entrepreneurs that fuel the important companies of tomorrow will always need venture capital and the quality professionals who provide it. When technological changes are

moving fast, the case for venture capital is strong.

[Tell us what you think](#) (survey)

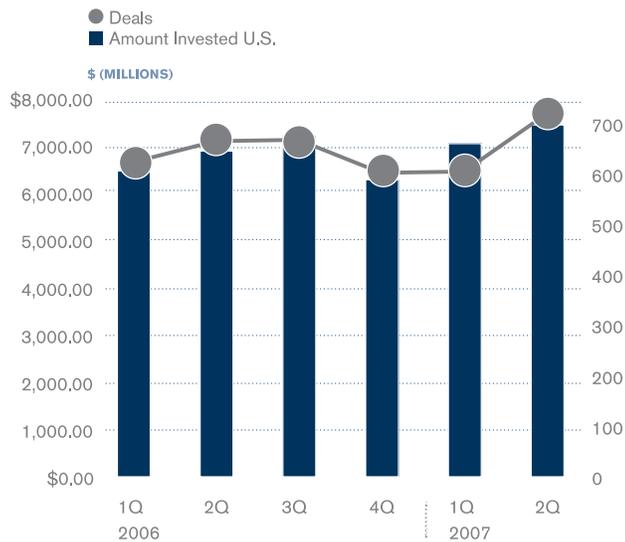
Send your comments and suggestions for topics to Bronwyn Dylla at [bdylla@svb.com](mailto:bdylla@svb.com).

- 1 DowJones Venture Source. "Venture Capital Industry Overview – Q2 2007."
- 2 Assuming that the number of exits in 2006 remains constant each year and that new companies funded net out failing companies, it would take 5,500 companies about 12 years to complete 460 exits per year.
- 3 Source: DowJones Venture Source. "Venture Capital Industry Overview – Q2 2007."
- 4 Private Equity Week, August 3, 2007.
- 5 The J-curve refers to the shape of the plotted realized returns generated by a fund from inception to termination. Initial returns dip into the negative range due to the payment of management fees and during the first draw-downs. As realizations are made, returns increase and typically rise steeply into the positive zone on the plotted curve.
- 6 Steve Bird. "Private Equity...or Personal Equity? Why Who You Know Still Drives Venture Capital Returns," Focus Ventures. Website: [http://www.focusventures.com/whitepaper\\_who\\_you\\_know.pdf](http://www.focusventures.com/whitepaper_who_you_know.pdf).
- 7 Christophe Rouvinez. "Top quartile persistence in private equity," *Private Equity International*, June 2006. These percentages are notably higher than a 20 percent probability, based on chance (outcome set = first quartile, second quartile, third quartile, fourth quartile, and no follow-on fund raised).
- 8 For further discussion on brand power in the venture industry, see Doug Hamilton and Natalie Braun, "Do VC Brands Matter?" *Venture Capital Update*, SVB Capital, June 2005. [http://www.svb.com/pdfs/vc\\_2005\\_q1.pdf](http://www.svb.com/pdfs/vc_2005_q1.pdf).
- 9 Dow Jones, Venture Source. "Venture Capital Industry Overview – Q2 2007."
- 10 By contrast, missing performance targets can cause the market to punish a company. MetroPCS (PCS), the largest IPO in Q2 2007, saw its share price fall in early August when it announced that its Q2 2007 subscriber numbers did not meet its forecast.
- 11 The second highest year during this period was 2000 at 11,284 design patents. Source: U.S. Patent and Trademark Office. "Design Patents Report," [www.uspto.gov](http://www.uspto.gov).
- 12 Stephen Minton et al. "U.S. IT Spending 2006-1020 Forecast," IDC, 2007.
- 13 IDC. "Worldwide Enterprise Converged Mobile Device 2007-2011 Forecast and Analysis," June 2007.
- 14 Attributed to Citigroup Investment Research by the *Wall Street Journal*. "For IT, 'Dull' Sounds Pretty Good," May 29, 2007. The survey of 100 CIOs was taken in March 2007.

\* This update is for informational purposes only and is not a solicitation or recommendation that any particular investor should invest in any particular industry, security, or fund.

## SECOND QUARTER 2007 U.S. PRIVATE EQUITY SNAPSHOT

### U.S. VENTURE INVESTING ACTIVITY



Source: Dow Jones VentureOne and Ernst & Young Quarterly Venture Capital Report

### MOST ACTIVE VENTURE INVESTORS

Firm Name	Under Mgmt	# of Deals
Intel Capital*	\$ 1,130	24
New Enterprise Associates	8,500	16
Draper Fisher Jurvetson	3,000	15
Lightspeed Venture Partners	1,300	15
Sequoia Capital	2,153	15
Alta Partners	2,000	13
U.S. Venture Partners	3,200	13
Accel Partners	3,000	12
Atlas Venture	2,400	12
Morgenthaler	2,000	12
Sevin Rosen Funds	1,800	12
InterWest Partners	2,112	11
Matrix Partners	2,500	11
VantagePoint Venture Partners	4,000	11

\*Corporate Venture Capital  
Source: Dow Jones VentureOne

### VENTURE INVESTMENT BY REGION, ALL INDUSTRIES

Region	# of Deals	# of Investing firms	Average Per Deal	Sum Inv. (\$ MILLIONS)
Bay Area	208	300	\$ 12.8	\$ 2,511.5
New England	96	166	8.4	795.1
New York Metro	64	126	11.4	667.3
Los Angeles	35	70	15.1	459.2
San Diego	27	78	14.9	382.1
Southeast	55	89	6.7	365.2
Washington State	32	56	9.7	300.0
Colorado	20	49	14.6	275.9
Potomac	26	50	11.2	262.2
Texas	25	48	10.2	233.2
Orange County	14	46	13.5	176.0
Midwest	13	37	12.6	159.8
Research Triangle	20	42	8.8	159.4
Philadelphia	14	33	9.6	114.9
Oregon	10	27	12.1	114.5
Southwest	7	22	11.9	86.6

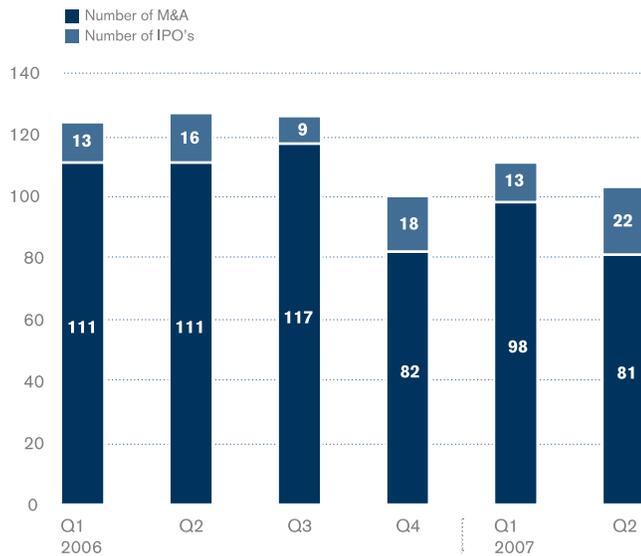
Source: Dow Jones VentureOne

### FUNDRAISING BY U.S.-BASED VENTURE AND LBO/MEZZANINE FIRMS



Source: Thomson Financial Venture Economics / National Venture Capital Association

U.S. IPOs VS M&A TRANSACTIONS FOR VENTURE-BACKED COMPANIES



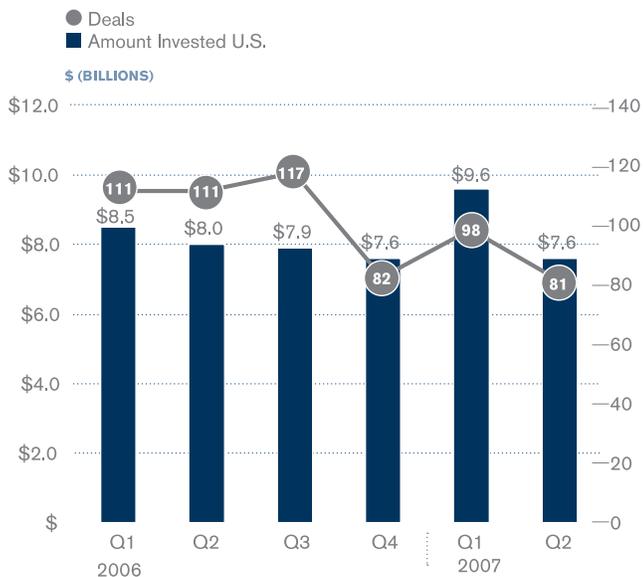
Source: Dow Jones VentureOne and Ernst & Young Quarterly Venture Capital Report

U.S. VENTURE LIQUIDITY EVENTS BY INDUSTRY

Industry	2005		2006		1H 2007	
	IPO	M&A	IPO	M&A	IPO	M&A
Biopharmaceuticals	14	40	20	29	11	9
Healthcare Services	0	11	0	7	0	3
Medical Devices	7	14	6	23	4	7
Medical IS	1	18	2	17	0	3
Comm. and Networking	3	40	5	49	6	20
Elect. & Computer Hdw.	1	12	1	14	1	4
Information Services	0	42	5	47	3	26
Semiconductors	4	17	2	18	3	9
Software	3	148	7	158	4	72
Other	10	70	8	59	3	26
<b>TOTAL</b>	<b>43</b>	<b>412</b>	<b>56</b>	<b>421</b>	<b>35</b>	<b>179</b>

Source: Dow Jones VentureOne and Ernst & Young Quarterly Venture Capital Report

U.S. VENTURE-BACKED M&A ACTIVITY



Source: Dow Jones VentureOne

CUMULATIVE IRR PERFORMANCE (%) BY STAGE (U.S.)

Fund Type	Num of Funds	Cap Wtd Avg	Pooled Avg	Upper Quartile	Median	Lower Quartile
Early/Seed VC	563	8.5	19.5	15.5	3.1	(5.6)
Seed Stage VC	65	3.9	9.5	13.3	3.9	(2.6)
Early Stage VC	498	8.7	20.4	15.9	3.0	(5.8)
Balanced VC	444	8.1	14.1	15.0	5.5	(1.0)
Later Stage VC	191	7.4	13.7	16.8	6.5	(0.9)
All Venture	1,198	8.1	15.9	15.5	4.5	(3.0)
Small Buyouts	179	8.7	24.9	17.8	7.7	(0.3)
Med Buyouts	108	13.1	17.7	22.1	9.7	(0.1)
Large Buyouts	91	8.9	12.8	17.4	6.9	(2.0)
Mega Buyouts	117	10.0	12.0	20.1	8.7	0.1
All Buyouts	495	10.1	13.8	18.5	7.9	(0.4)
Mezzanine	72	5.8	8.8	12.8	7.8	1.3
Buyouts and Other PE	654	9.9	12.9	17.8	7.9	(0.1)
All Private Equity	1,857	9.4	14.3	16.3	6.0	(1.9)

Source: Thomson Financial Venture Economics / National Venture Capital Association, data as of March 31, 2007

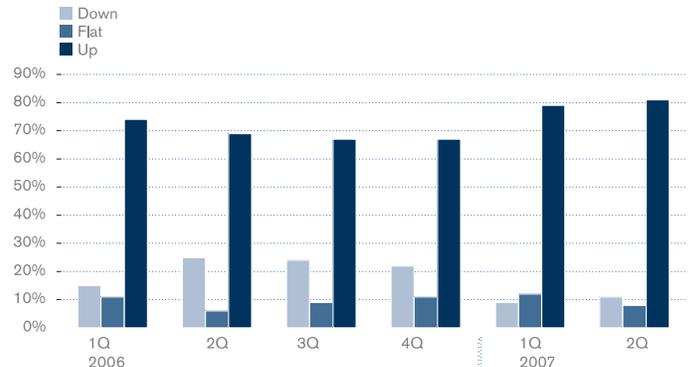
IRR PERFORMANCE (%) BY VINTAGE YEAR (U.S.)

Vintage Year	Num of Funds	Cap Wtd Avg	Pooled Avg	Upper Quartile	Median	Lower Quartile
1996	35.0	59.6	83.7	114.0	32.5	1.6
1997	61.0	46.7	50.1	59.8	20.3	0.4
1998	76.0	24.7	20.6	10.7	1.7	(4.7)
1999	110.0	(8.0)	(6.7)	0.5	(8.1)	(17.5)
2000	120.0	(0.6)	0.6	1.0	(3.8)	(8.0)
2001	54.0	2.2	3.0	7.6	-	(3.5)
2002	19.0	(0.4)	1.5	3.4	(2.6)	(3.6)
2003	14.0	(0.3)	1.0	3.3	(3.4)	(5.5)
2004	19.0	(2.7)	2.4	1.5	(6.0)	(13.6)
2005	10.0	(3.0)	(1.9)	5.5	(4.1)	(5.8)
2006	13.0	(19.8)	(15.6)	(9.9)	(21.9)	(36.5)

Source: Thomson Financial Venture Economics / National Venture Capital Association; data as of March 31, 2007

PRICE CHANGE

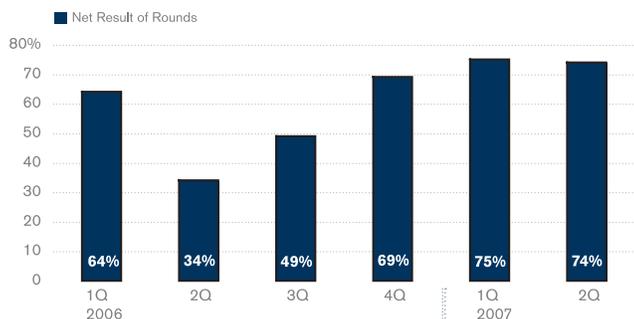
The direction of price changes for 126 San Francisco Bay Area companies receiving financing, compared to their previous rounds.



Source: Fenwick & West L.L.P.

VENTURE CAPITAL BAROMETER™

Average per share % price change from previous round of Silicon Valley companies receiving VC investment in the applicable quarter. Complete report available at <http://www.fenwick.com/vctrends.htm>



Source: Fenwick & West L.L.P.

SVB  *Find a way*

SVB Financial Group

SVB CAPITAL HEADQUARTERS

2400 Hanover Street Palo Alto, California 94304 U.S.A.

PHONE 650.855.3000

3000 Sand Hill Road, Building 3, Suite 150 Menlo Park, California 94025 U.S.A.

PHONE 650.233.7420

[svb.com](http://svb.com)

© 2007 SVB Financial Group.<sup>SM</sup> Member Federal Reserve. All rights reserved. SVB, SVB> and SVB>Find a way are all service marks of SVB Financial Group. SVB Capital is a non-bank member of SVB Financial Group. Products and services offered by SVB Capital are not insured by the FDIC or any other Federal Government Agency and are not guaranteed by Silicon Valley Bank or its affiliates. Rev 10-22-07.