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Venture Investing After the Bubble: A Decade of Evolution



Some have labeled the last ten years in the venture capital industry a *decade of lost returns*. Ten and 11-year industry benchmarks show a negative Internal Rate of Return (IRR) for venture capital investments. Some investors have questioned if the venture capital model is broken and in need of dramatic overhaul. A deeper analysis of underlying trends in the venture industry over the past decade paints a more nuanced and — especially in the case of the leading firms — a more positive picture of the industry's performance and outlook. This article explores these trends, highlighting key challenges and emerging opportunities impacting the venture industry, and segmenting the previous decade by vintage year groups based on current and expected performance.

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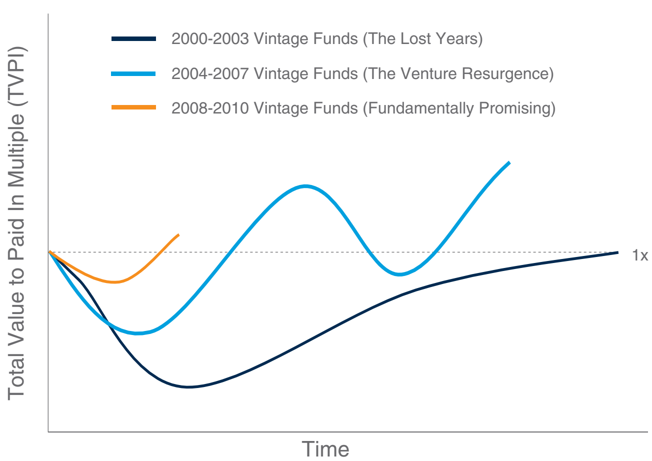
Specifically, three vintage profiles emerge in this analysis

2000-2003 – The Lost Years

The performance of many of the funds in these vintage years is a key driver behind the industry's overall negative 10-year return. Venture investors were in the process of regaining their footing following the tech crash of 2000-2002; portfolios struggled to climb out of holes generated by significant early write-offs; and the fundamental opportunity set for venture investors was in flux. This high degree of uncertainty impacted the venture industry immediately following a period of unprecedented fundraising activity. The venture industry was overcapitalized and the relatively high write-off rate early in portfolios' development (see Exhibit 4) supports the view that too many companies received funding. For the few funds that did manage to create some performance momentum early in their development, the global financial crisis of 2008-2009 closed the exit window for their portfolios at a crucial juncture.

In general, funds in this early part of the decade are 100 percent called today and value changes are largely limited to increases in distributed value (versus expansion in funds' NAV) as managers actively harvest remaining value and work towards closing funds in the coming years. This trend of limited value creation in the current environment is illustrated in Exhibit 1, which shows the historical total value to paid in capital multiple (TVPI)[1] trend (the J-curve) of a sample 2000-2003 vintage venture fund compared to the other vintage segments analyzed in this article. There are exceptions, and within SVB Capital's own portfolio 2000-2003 vintage funds are projected to experience some additional TVPI expansion, ranging from 15 percent in the low case to 70 percent in the high case. Overall, very few funds in this vintage segment will generate the 2x+ multiple that limited partners in the venture space target. However, it is encouraging to note that even in the most challenging period for venture investing, we expect the leading firms to at least return capital to investors, with the strongest funds expected to generate 1.25x to 1.75x return multiples.

Exhibit 1: Model 'J-Curves' for 2000-2010 Vintage Venture Capital Funds



Source: SVB Capital

2004-2007 – The Venture Resurgence

In 2004, fundraising increased meaningfully from the bottom of the fundraising market in 2003. The best venture firms approached new investments armed with the experience and lessons learned from the tech market crash. The funds raised during this period were well-positioned to invest in the early stages of many trends that have subsequently reshaped the technology landscape: software as a service, social networking, improved enterprise storage solutions, and innovative approaches to e-commerce, to name a few. Although the global financial crisis in 2008 did impact many of the portfolios in these vintage years as enterprises cut spending, consumer sentiment soured and exit and credit markets closed, the savviest investors responded proactively at the onset of the crisis by helping portfolio companies insulate themselves as much as possible from the downturn. New investment levels fell sharply in late 2008 and 2009, but most existing portfolio companies survived intact.

Limited partners actively investing in venture during the 2004-2007 time frame experienced a rollercoaster of valuation shifts (see Exhibit 1). Fortunately, multiple aspects of the analysis in this *VC Update* indicate that the leading 2004-2007 vintage funds are well-positioned to generate very strong returns for limited partners. For those funds that deployed significant capital prior to the economic downturn, our analysis of write-off trends indicates that proactive portfolio management resulted in only a moderate increase in write-offs. Those funds that were slow to deploy capital prior to the downturn — either because of concerns regarding valuations or simply the timing of fundraising — were well-positioned to take advantage of the moderately lower valuation environment during the downturn. The improvement in the venture-backed exit and fundraising environment following the global financial crisis is driving significant value increases for these funds. Also of importance, funds in this vintage year segment have substantial early-stage exposure to companies that are currently breaking out as clear winners — Facebook and Groupon, for example — as well as some of the more exciting venture backed exits in recent years such as LinkedIn, HomeAway, Fusion-IO, Advanced Biohealing and AdMob. The investment outcomes generated by some of these companies are expected to be significant to the extent that they drive fund level returns for select funds that have not been witnessed since the late 1990s.

SVB Capital anticipates continued growth in both realized and unrealized value for 2004-2007 vintage funds. Although significant uncertainty remains given that portfolios of many funds in this vintage year segment are still in the mid stages of their development, there is a feasible path to overall net returns of 2.5x+ for upper quartile 2004-2007 vintage funds with several funds generating 5-10x+ multiples.

2008-Today – Fundamentally Promising

The venture industry today is very different from where it was in the late 1990s and early 2000s. The number of active firms has plummeted since 2007, falling nearly 50 percent, and the amount raised for new venture funds has been well below $20 billion in 2009 and 2010, representing roughly 15 percent of the 2000 total ($105 billion). As capital flowing into the venture industry has decreased, the opportunity for entrepreneurs has evolved dramatically, and the barriers to entry in starting a new company are fewer than ever before. This increasing ease in starting and growing a business is aptly referred to as the democratization of entrepreneurship and it is a trend that is poised to continue. Funds raised in more recent vintage years have allocated increasing capital to seed rounds and late-stage rounds seeking to participate in both the explosion of new companies, as well as the rapid value expansion of breakout late-stage companies leading new segments of the industry.

Key performance trends in the most recent vintage years are shortened J-curves (see Exhibit 1) driven by significant early write-ups in unrealized value as investors aggressively pursue stakes in emerging industry leaders, and expectations of some early fund liquidity generated by late-stage investments in companies expected to exit in the coming six to 12 months. It is too early in the development of these funds to identify likely return outcomes, but the fundamentals of the industry — significantly lower fundraising levels and a universe of investment opportunities that is more attractive and dynamic than ever before — are encouraging.

Transformative Crises

The previous decade of venture investing was shaped by two major economic events: the aftermath of the technology bubble and the global financial crisis of 2008 and 2009. The initial impact and ongoing legacy of these two economic collapses on the venture industry differs, and these differences are reflected in industry performance trends.

Summary of Key Factors Impacting the Last Decade of Venture Capital

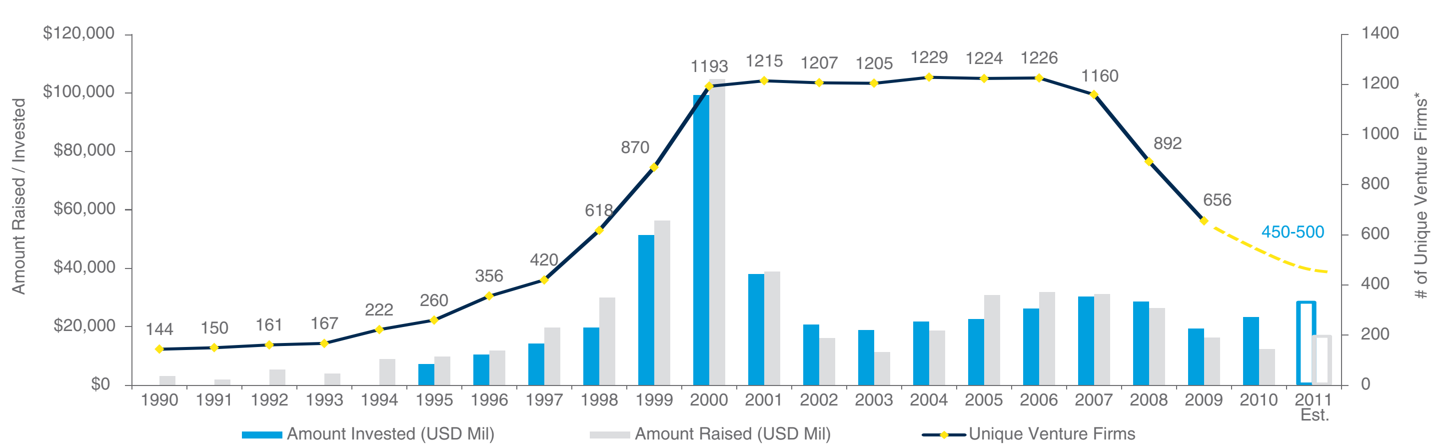
Vintage Era	Industry Fundamentals	Pros	Cons	Performance Expectations
2000-2003	Highly overcapitalized ◦ Unprecedented fundraising levels ◦ Uncertain investment landscape	◦ Well positioned for strong exit markets in 2004-2007	◦ Unprecedented early write-off activity ◦ Global financial crisis closed exit markets at pivotal time	Industry: <1x Upper Quartile: 1.25-2x Outperformers: 2-3x
2004-2007	Moderately Overcapitalized ◦ Lower fundraising levels ◦ Too many active firms ◦ Attractive opportunity set for new investments	◦ Early exit activity generated by strong 2004-2007 exit market ◦ Attractive valuation environment for new investments in 2008 and 2009 ◦ Early exposure to breakout companies currently reshaping the industry	◦ Large fund sizes will dilute returns for some firms ◦ Global financial crisis delayed some exits and will have a negative IRR impact	Industry: ~1.5x Upper Quartile: 2.5-3.5x Outperformers: 5x+
2008-Today	Highly attractive ◦ Decreased fundraising levels driving strong competition between venture firms and higher quality bar for new investments ◦ Highly attractive, increasingly global opportunity set for new investments	◦ Capital efficiency is front of mind for investors and entrepreneurs ◦ Fewer barriers to entry for startups ◦ Strong performers are generating substantial early revenue growth ◦ M&A market is robust for VC-backed companies	◦ High valuation environment for high-profile companies (proprietary dealflow and discipline are critical)	Too early to tell, but early exit activity and very short j-curve is encouraging

The technology bubble had a direct and profound impact on the venture industry. The strong venture-backed exits of the late 1990s (which had the greatest positive impact on 1994-1997 vintage funds) fed a sudden increase in venture capital fundraising. Investment pace skyrocketed as venture firms chased the unparalleled returns created by the public market appetite for new technology companies. Some of these successful exits during the technology bubble were generated by companies that continue to shape the industry today — Amazon.com, Ebay, and Juniper Networks, for example — whereas others came from companies that were riding a wave of momentum and very quickly came crashing down to reality when the NASDAQ plummeted from a high of 5049 in March 2000 to 1720 in April 2001. The impact of the technology bubble on the venture industry was especially profound because many in the industry believed that the exits of the 1998-2000 era were the new normal. Limited partners flooded into the market, resulting in a venture capital industry that was more heavily capitalized than ever before (see Exhibit 2), while the opportunity set for new investments was highly uncertain.

The global financial crisis that started in the fall of 2008 had a broad impact on the overall U.S. economy. Venture firms, having learnt from and suffered through the aftermath of the technology bubble, were proactive in taking steps to insulate their portfolio companies from the downturn. Company cash burn rates were slashed in expectation of decreased revenues; firms actively triaged their portfolios and allocated follow-on capital only for the strongest companies; and the trend towards focusing on capital efficient businesses accelerated. The global financial crisis caused dramatic drops in public markets around the world, which forced pensions, endowments and foundations to significantly reshuffle their overall portfolios. Allocations for venture capital along with other illiquid alternative investments were cut (some temporarily, some permanently), making fundraising nearly impossible for all but the strongest firms. Exhibit 2 highlights that the number of active firms in the industry has fallen approximately 50 percent as a result of decreasing investor demand for venture capital. This steep decrease in fundraising has driven strong competition between venture firms for limited partners' commitments, which has in turn increased the quality bar for new portfolio company investments and created stronger LP-GP alignment (some firms are adopting more LP-friendly fund terms to facilitate more efficient fundraising).

Overall, many of the potential negative impacts of the global financial crisis were mitigated by the proactive response of leading firms at the downturn's onset. The uncertainty in late 2008, 2009 and early 2010 delayed exit events for some mature portfolios (2000-2006 vintages). However, for funds that were earlier in their development (2007-2008 vintages), strong early-stage portfolio companies continued to grow and raise follow-on financing throughout the downturn, and

Exhibit 2: Number of Venture Capital Firms*, Industry Fundraising and Amount Invested



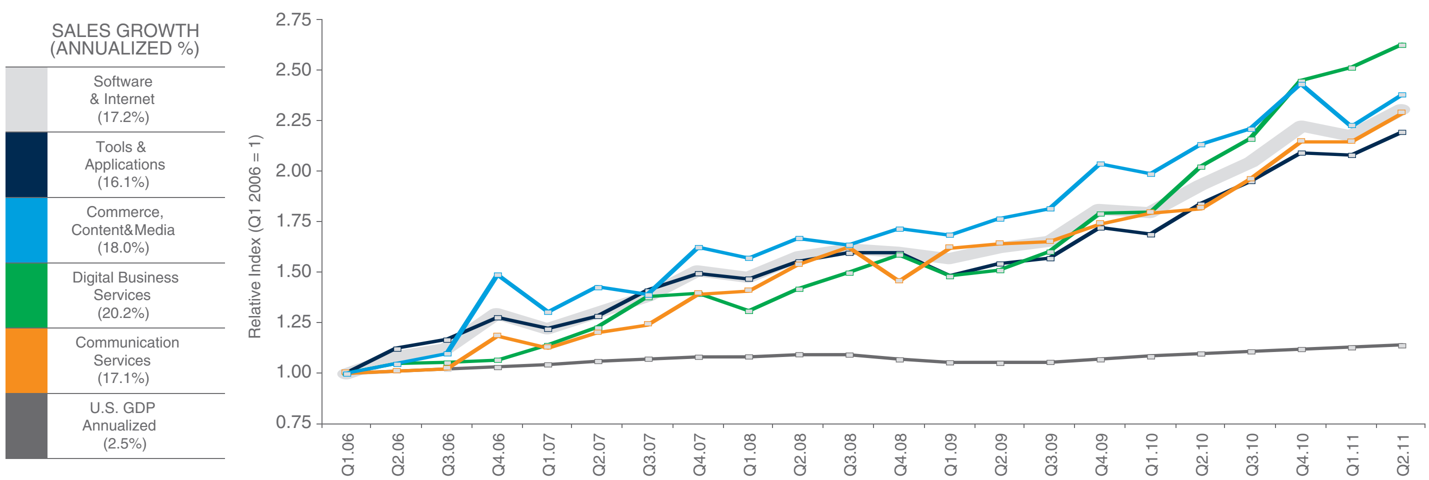
** VC firms that have at least one round of investing in the year*
Sources: Dow Jones VentureSource and SVB Analytics. "Amount Invested" data unavailable prior to 1995.
Note: 2010 and 2011 data for # of unique firms and amount raised are projections based on SVB Capital analysis

the valuation environment for new investments was attractive. Importantly, revenue trends for venture-backed IT companies have largely been uncorrelated with the broader U.S. economy in recent years, validating that the technology industry has been a critical source of economic growth in an otherwise stagnant economy (see Exhibit 3).

Exit and Valuation Trends

Many of the trends identified above are evident in industry data.[2] There are inherent inconsistencies in comparing time and capital invested before exit across different vintage year segments of the previous decade. This analysis focuses on both early liquidity trends (those exits that happen within three years of a company's initial round of institutional funding[3]) in addition to longer-term exit activity. Exhibits 4 and 5 provide context for the early exit trend analysis detailed below. The data highlights that early write-off activity as well as the number of companies receiving their first round of funding have fallen substantially since the 2000-2003 time frame. This observation is directly tied to the unprecedented high level of venture fundraising in 1999 and 2000 discussed earlier in this *VC Update*. The overcapitalization of the industry led to a faster investment pace and a sudden increase in the number of new firms active in the market. The quality bar for new investments was lowered as a result, and the rapid shift in exit markets and the broader economy in

Exhibit 3: Sales Growth Comparison (Q1 2006 – Q2 2011)*



Source: SVB Analytics Research, SVB Proprietary Data
**Note: This data is based off of a representative sampling of SVB clients across the United States*

Exhibit 4: Detailed Early Exit Trend Statistics

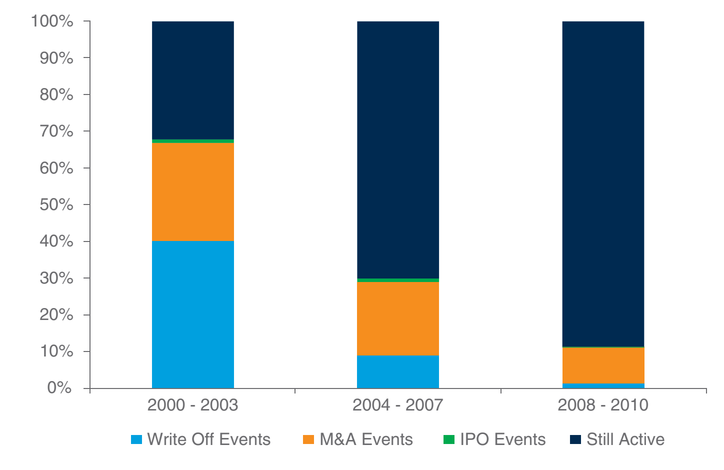
Vintage Era	Companies Receiving First Round of Funding ("N")	Write Offs		M&A (Value Disclosed)		M&A (Value Undisclosed)		IPO		Still Active Three Years After Receiving Initial Funding Round*	
		# of Events	As a % of Total	# of Events	As a % of Total	# of Events	As a % of Total	# of Events	As a % of Total	# of Events	As a % of Total
2000-2003	5364	2153	40.1%	477	8.9%	958	17.9%	47	0.9%	1729	32.2%
2004-2007	4483	401	8.9%	270	6.0%	628	14.0%	36	0.8%	3148	70.2%
2008-2010	3354	44	1.3%	72	2.1%	260	7.8%	3	0.1%	2975	88.7%

**Note: The 2008-2010 time vintage era figures do not capture the same breadth of data captured in the other vintage eras given that many of the investments in this timeframe are still in their first or second year of development*

Source: Dow Jones VentureSource

2001 led to a deluge of write-off activity. Approximately 40 percent of the companies that received funding in the 2000-2003 time frame were out of business within three years, compared to 9 percent in the 2004-2007 era.

Exhibit 5: Outcome of Investments during Three Year Period from Initial Funding Round – Exits and Active Companies

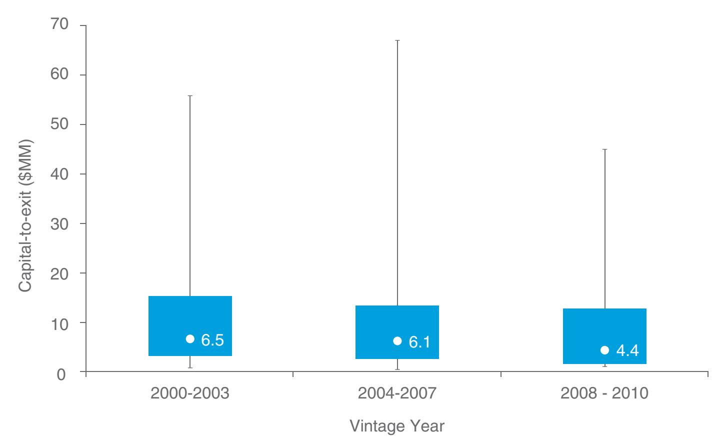


Source: Dow Jones VentureSource

Early Liquidity Trends: Capital to Exit and Exit Values

As illustrated in Exhibit 6, the early exits that have thus far occurred in the most recent vintage year segment, 2008-today, required less invested capital than early exits in prior vintage year segments. This is partially attributable to the inherent inconsistencies in comparing the most recent vintage era to earlier eras, which encompass a longer time period. It is, however, informative when evaluated in the context of Exhibit 7, which highlights that the early M&A exits in the most recent vintage era have a higher exit value on average then prior vintage year segments. These diverging trend lines — decreasing capital requirements and increasing exit values — is encouraging and illustrates that in today's more capital efficient technology industry, startup companies are able to scale a business with less invested capital than was previously possible. Even in segments of the venture industry that have traditionally been more capital intensive — cleantech and life sciences, for example — investors are increasingly focused on more capital efficient investment strategies. In life sciences, this can mean identifying corporate partnership opportunities early in a company's clinical trials to help ease the burden of raising sufficient venture funding to support a company throughout the long approval process. In the cleantech space, this shift towards capital efficiency increased investors' focus on companies applying IT solutions to cleantech-related problems, such as software solutions focused on energy efficency.

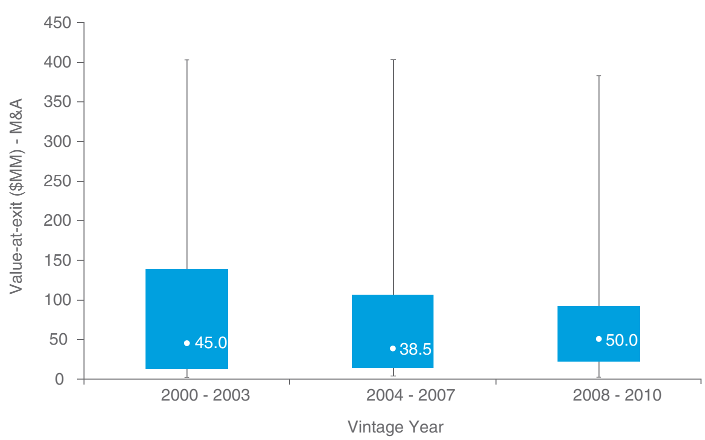
Exhibit 6: Capital to Exit for Exits Generated within Three Years of Initial Investment[4]



Source: Dow Jones VentureSource

The ability for startup companies to build significant businesses with less capital than was previously required is one reason why there has been an increase in seed and early-stage focused investors in recent years. The typical angel strategy of investing a small amount ($500K to $2M) very early in a company's development can generate a strong multiple even at a relatively small exit value ($30-$50M), assuming that the angel investor does not suffer significant dilution prior to exit. The increase in angel activity in recent years combined with the decreasing number of traditional early-stage venture firms has raised the possibility that many of the companies that raised angel funding in recent years will struggle to generate interest from the limited number of active series A and B investors. Some companies will be forced to find a way to be even more capital efficient in an effort to increase their runway as they work towards some sort of milestone that will generate stronger interest from venture firms. Other companies may seek to sell early, before they've had a chance to grow. And lastly, we will likely see an increase in write-offs of seed investments, consistent with the higher risk nature of investing at the earliest stages of a startup company's development. The increasing quality bar for series A investments from active venture firms means that only those companies pursuing enormous market opportunities are consistently garnering strong investor interest.

Exhibit 7: Disclosed M&A Values at Exit



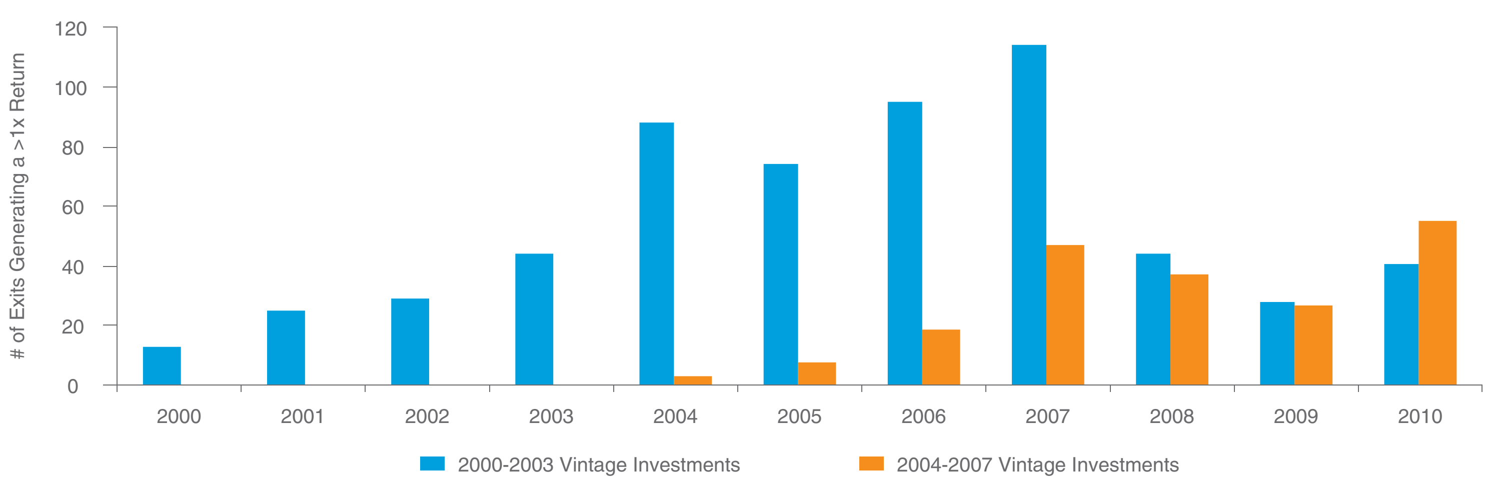
Source: Dow Jones VentureSource

Longer Term Exit Trends

As illustrated in Exhibit 8, funds active in the 2000-2003 time frame were well-positioned to benefit from the relatively strong exit markets of 2004 to early 2008. As is typical in today's venture industry, the majority of these exits were generated by M&A transactions, although IPO activity did increase substantially in 2006 and 2007, reaching 35 percent of all >1x exits in 2007. Early exit trends for 2004-2007 vintage investments were promising as breakout companies took advantage of the strong exit markets in the years prior to the global financial crisis. Exits for the investments captured in this analysis dropped along with the overall exit market in 2008 and 2009 and subsequently recovered slightly in 2010. Although exit activity increased for the 2000-2003 vintage investments following the recent downturn, we have observed that most of these exits are relatively low value outcomes. 2004-2007 vintage investments, on the other hand, are driving much of the value expansion (realized and unrealized) that has occurred in 2010 and 2011.

Exhibit 8, at first glance, seems to contradict the argument that 2004-2007 vintage investments are poised to outperform 2000-2003 investments. The number of companies that were funded in 2000-2003 and subsequently generated 1x+ exits is higher than the 2004-2007 cohort on both an absolute and relative basis (refer to exhibit 10 to see this data as a percetnage of the total number of companies funded). However, these positive outcomes were offset by the high early write-off activity of 2000-2003 investments (Exhibit 9), which substantially exceeds early write-off activity for 2004-2007 investments.

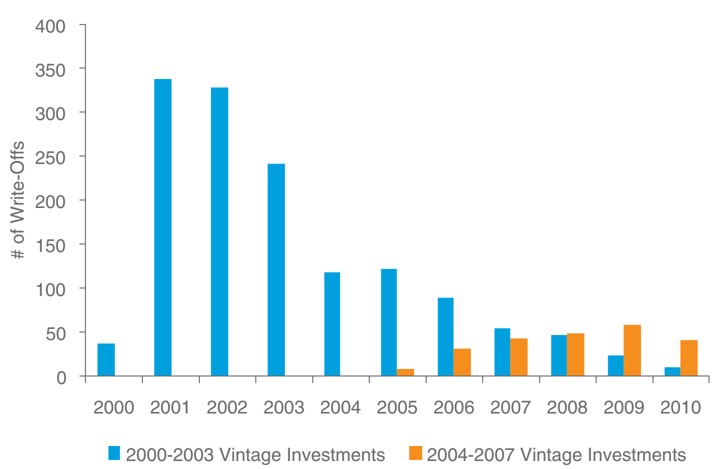
Exhibit 8: Exits Generating a >1x Return Multiple



Source: Dow Jones VentureSource
Note: Refer to Exhibit 4 for the # of companies captured in each vintage year segment

Interestingly, there was no noticeable increase in write-offs of 2000-2003 vintage investments during the recent economic downturn (see Exhibit 9). It is likely that the 2000-2003 vintage investments that did not fail or exit prior to late 2008 had generally reached a stage in their development where they had limited need for outside investment and were thus not targets of investors' efforts to cull their portfolios of underperforming investments. There are select examples in 2000-2003 vintage funds of companies that weathered the downturn and emerged in early 2010 to continue growing revenues and progressing towards a strong exit, but these companies are an exception to the rule. Write-off activity for 2004-2007 vintage funds increased in 2008 and 2009, but still pales in comparison to the early write-offs that have plagued the performance of many funds actively making investments from 2000 to 2003.

Exhibit 9: Write-Off Activity



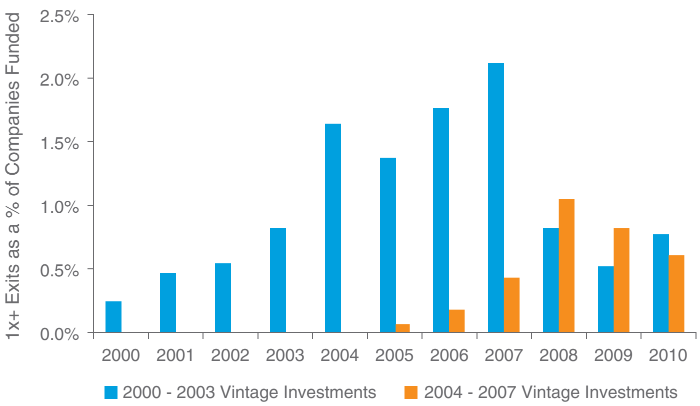
Source: Dow Jones VentureSource
Note: Refer to Exhibit 4 for the # of companies captured in each vintage year segment

Poised for a Resurgence

To say that the last decade in venture is a *decade of lost returns* is misleading. As detailed in this *VC Update*, the reality is far more nuanced and encouraging. 2000-2003 vintage funds — several of the most challenged vintage years in the history of the industry — are a byproduct of a venture industry that was severely overcapitalized. Despite unprecedented write-off activity early in their portfolios' development, many of the leading funds will still manage to return committed capital to LPs, with the strongest funds expected to generate an eventual return multiple of 1.25x to 1.75x. 2004-2007 vintage funds have early exposure to many of the breakout companies reshaping the industry and were well-positioned to take advantage of both the attractive valuation environment during the global financial crisis and the more recent resurgence in private company valuations. As a result, the leading 2004-2007 vintage funds are on a trajectory to generate very strong venture returns with some funds reaching return levels reminiscent of the 1994-1997 era. The current environment for venture investing is fundamentally compelling. The venture industry's evolution over the previous decade has resulted in a much smaller pool of capital being deployed into a growing, increasingly global set of opportunities. With these industry dynamics, the opportunity for leading venture investors to generate exceptional returns is clear. The challenge for limited partners is not the fundamental venture capital opportunity; it is identifying, accessing and investing in the best funds.

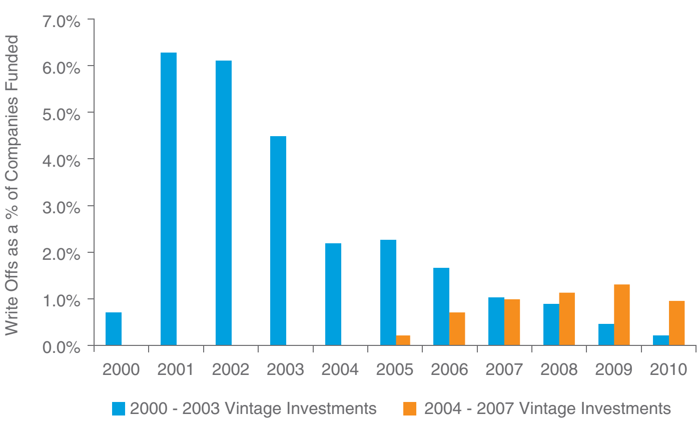
Appendix

Exhibit 10: Exits Generating a >1x Return Multiple as a Percentage of Total Companies Funded in Each Vintage Year Segment



Source: Dow Jones VentureSource
Note: Refer to Exhibit 4 for the # of companies captured in each vintage year segment

Exhibit 11: Write-offs as a Percentage of Total Companies Funded in Each Vintage Year Segment



Source: Dow Jones VentureSource
Note: Refer to Exhibit 4 for the # of companies captured in each vintage year segment

About SVB Capital

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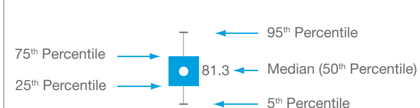
1 TVPI is the abbreviation for a fund's total value to paid in capital multiple. Total value encompasses both realized and unrealized value.

2 This analysis uses the date of the initial round of venture funding to assign a company to a specific vintage year. As such, the 2000-2003 vintage year segment in these numbers, for example, is only an approximation for 2000-2003 vintage venture funds. Given that most venture funds have an initial investment period of two to four years, these numbers are a relatively accurate reflection of the portfolios of 2000 and 2001 vintage funds, but only partially reflective of the portfolios of 2002 and 2003 vintage funds, which also likely deployed capital in 2004-2007.

3 This methodology also has shortcomings in that the exit timeframe included in this analysis for the 2008-today segment is significantly shorter than the 2000-2003 and 2004-2007 segments, which extends three years beyond the last vintage year in each category. It is, however, the best indicator of how early exit trends for this most recent segment compare to previous years in the last decade.

Legend



4 How to read Boxplot Charts: In this example the distribution of data varying from the median (50th Percentile) value, represented numerically as 81.3, is illustrated where the middle 50% of the distribution is depicted by the colored box (ranging from the 25th to 75th percentile) while the span of the whiskers portrays the middle 90% of the distribution (ranging from the 5th to the 95th percentile).

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