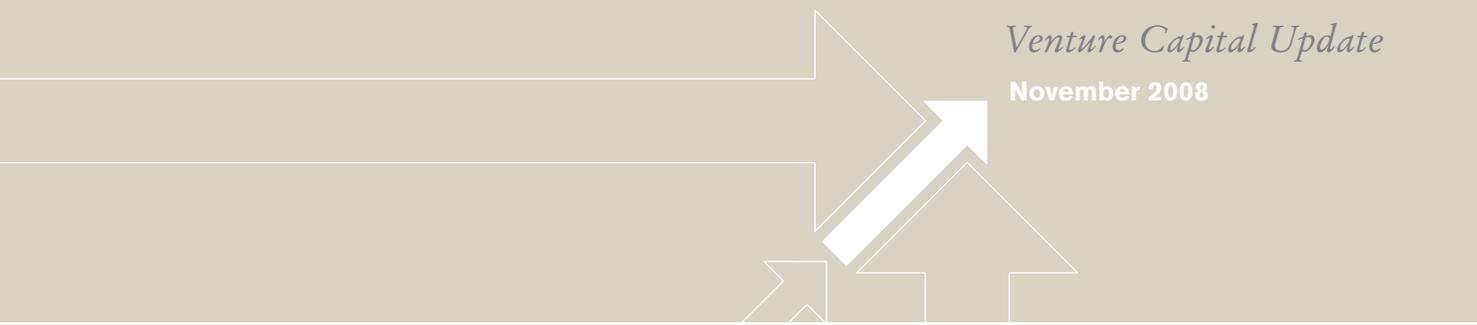


Venture Capital in Uncertain Times: Observations and Predictions



Venture Capital Update

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Today's news of the shrinking economy, falling stock markets and Wall Street failures has many investors uncertain where to turn. During the credit crunch some investors believed that venture capital would be relatively immune to the financial crisis, but now venture capitalists are calling on portfolio companies to gear up for bad times. In this article, SVB Capital provides our observations of how the current macroeconomic trends have affected venture capital and our predictions of how they will shape the asset class in the near future. When the markets stabilize and after the economy rebounds, we expect to see fewer active

venture firms, stronger portfolio companies and less competition from buyout and hedge funds for limited partners (LPs). In the near-term, both venture funds and portfolio companies are going to face significant challenges raising capital. Over the long run, these changes provide reasons for optimism about the industry.

OBSERVATIONS ABOUT VENTURE CAPITAL TODAY

1. Venture capitalists are conserving capital

In recent weeks venture capital firms have begun advising their

Our thanks go to Harry Kellogg and John Dominguez for providing comments and suggestions on earlier drafts.

portfolio companies to remain disciplined in their spending to endure the economic slowdown. Most notably, Sequoia Capital held a meeting for its portfolio companies informing them that the good times are over. Like Sequoia, many analysts expect the current downturn in the economy to be long and painful. No one knows when the credit market will open up or when the economy will rebound. To be prudent, companies must conserve capital and cut spending. Often, the best way for young companies to achieve their highest performance is by keeping a low cash burn rate to get to market, especially while products are still in development and timelines are uncertain. As one commentator reported, companies need to be the cockroaches of the corporate world—with the ability to survive any crisis—to achieve success.¹

Even before the height of the turmoil on Wall Street, VCs began husbanding their capital. Venture financings declined from \$7.9 billion in Q3 2007 to \$7.3

billion in Q3 2008,² the decline is expected to sharpen in the last quarter of 2008. Series B and C rounds have also become more challenging to raise. Instead, many venture capitalists are opting to bridge companies before raising a follow-on round or are advising portfolio companies to draw down credit lines. Considering current discounted valuations, it makes sense for venture capitalists to postpone B and C rounds until the markets rebound.

We also expect VCs to take it one step further by scrutinizing their portfolio companies more rigorously to distinguish the companies they expect to succeed through the downturn and the companies that will likely not make it. By culling their portfolio they will be able to more effectively focus scarce resources on their highest impact companies.

2. Venture-backed companies are holding ground

SVB Financial Group banks thousands of venture-backed clients through our banking

subsidiary, Silicon Valley Bank (SVB). During our earnings call for third quarter 2008 on October 23, 2008, SVB Financial Group indicated that it had thus far not seen any meaningful negative performance trends among our clients and further indicated that it had seen our clients, as a group, were growing revenues, although at modest levels. Similarly, based on our conversations with GPs, we found that venture-funded companies continue to meet their performance expectations. Although SVB provides loans to companies that receive venture financing as well as to companies without venture backing, it is notable that overall, in Q3 2008 SVB Financial Group's non-performing loans were only 0.18 percent of total gross loans, a reduction from 0.26 percent of total gross loans during the same period in 2007.³ Non-performing loans are indicators of the financial health of companies.

¹ Paul Graham, "Why to [sic.] Start a Start Up in a Bad Economy," <http://www.paulgraham.com/badeconomy.html>

² Dow Jones VentureSource.

³ SVB Financial Group Announces 2008 Third Quarter Financial Results," October 23, 2008. Nonperforming loans include loans past due 90 days or more and nonaccrual loans.

3. LPs are delaying new commitments to private equity

Declines in the stock market in 2008 have reduced the amount of capital available to commit to alternative assets. Many limited partner investors have been hit by the “denominator effect,” (i.e., the total amount of their assets has shrunk because of declines in their public portfolios). Their allocation to private equity — and venture capital in particular — has consequently increased when measured as a percentage of total assets. Many limited partner investors are likewise holding off or actively reducing their allocations to venture capital. This phenomenon has created a tough environment for fundraising and will dampen fund sizes over the coming years. We have already seen evidence of venture fundraising declines from \$8.6 billion in Q3 2007 to \$8.1 billion in Q3 2008.⁴

LPs are also facing constraints on liquidity with declines in the public market and are hesitant to sell positions that have been hit

by the current market decline. LPs rely on more liquid assets to generate the cash needed to fund operations and to meet capital calls. One result is that role of secondary funds will become more prominent as LPs obtain liquidity by selling their interests in private equity investments.

4. The credit freeze is hitting buyout firms and hedge funds hard⁵

With their reliance on debt financing, traditional buyout funds have been most affected by the lack and high cost of credit. But despite the Treasury’s efforts to loosen credit, some of the most prestigious buyout firms have already experienced significant public losses. One example includes the \$1.3 billion loss incurred by Texas Pacific Group (TPG) from its investment in Washington Mutual, which was sold to JPMorgan Chase for \$2 billion.⁶ Many private equity observers expect TPG’s reputation to be significantly impacted by this startling loss. Buyout-

backed bankruptcies, such as Linen ‘N Things, Steve & Barrys, and Mervyn’s, have become more common, particularly in the consumer sector, and some industry analysts expect buyout losses to grow.

Just as buyouts feel pain from the credit markets, hedge funds have suffered alongside public markets. According to Hedge Fund Research, the hedge fund industry shrank 11 percent during Q3 as investors pulled \$31 billion out of the industry, and funds are down 18 percent for the year.⁷ Without leverage and with recent limitations on short selling, hedge funds have fewer levers to drive returns. Redemptions are on the rise and will likely be a negative weight on equity returns for the coming months as these funds unwind. For instance, Citadel’s largest hedge fund, the \$10 billion Kensington Global Strategies Fund, is down 30 percent this year due to losses from convertible bonds, stocks and corporate debt.⁸

⁴ NVCA/Thomson Reuters. “Venture Capital Fundraising Activity Slows in the Third Quarter of 2008,” News Release, October 13, 2008.

⁵ Our thanks go to John Dominguez for his input on this section.

⁶ Maura Desmond. “Texas Pacific Group Survives WaMu Blow,” Forbes.com, September 26, 2008;

⁷ “Hedge fund assets shrink 11 percent in 3rd quarter,” Reuters, October 20, 2008.

⁸ Katherine Burton. “Citadel Hedge Fund Falls 30% on Bond, Stock Losses,” Bloomberg.com, October 16, 2008.

It is also likely that fewer hedge funds will be interested in investing in venture-backed companies in the short-term. Hedge funds have a shorter time horizon between time of investment and exit, and the lack of exits in the venture market will discourage hedge funds from participating even in late stage venture deals.

PREDICTIONS ABOUT THE NEAR FUTURE

1. LPs will favor venture over other types of alternative assets

The current financial and economic crisis has greatly impacted the availability of credit and public market returns. Challenges in the credit markets may persist for some time—perhaps years. Many asset classes competing for investments are pinched by this credit crisis in a very acute way. Competition for LPs will intensify because the available capital to invest has become even scarcer due to the denominator effect.

We have already begun to see reductions in funds raised by

buyout firms. Buyout fundraising fell from \$118 billion during the first three quarters of 2007 to \$103 billion during the same period in 2008.⁹ This decreasing trend began with the tightening of credit at the end of 2007 and is expected to decline further. Given the severe losses incurred by buyouts and hedge funds in recent months, SVB Capital expects to see a wholesale change in how institutions think about risk and asset allocations. Namely, the reliance on credit will be seen as an additional risk. Changes in LP investment strategy will benefit venture capital over other segments of alternative assets.

2. Vintage year will provide exceptional returns

Median venture valuations unexpectedly rose to \$24 million in H1 2008 from a median of almost \$18 million in 2007.¹⁰ Changes in valuations in the private market typically lag the public market pricing corrections, and we expect valuations at an industry level to decline over the next year or more. In addition to declining public valuations, venture capitalists'

prudence in providing capital will have a dampening effect on private company valuations. Because venture capitalists are conserving capital, they will exercise caution when negotiating interim rounds of financing and pick the strongest companies when providing first time infusions of capital. Given our expectations about declining valuations and the strength of companies receiving funding, first-time investments during 2009 (and perhaps in 2008 and 2010) should have an even greater potential to provide strong returns. In other words, vintage year 2009 has the potential to be exceptional.

3. The venture industry will have fewer and more diverse active firms

Dow Jones VentureSource estimates that only 620 venture firms backed new companies in 2007, compared to almost 1,200 active venture firms in 2000.¹¹ Despite this contraction, many VCs today believe that there are still too many funds and too much capital in the market. We believe that the current downturn will expedite the departure of

⁹ Keenan Skelly, "PE Fund-Raising Still Going Strong. Buyout Shops, Not So Much," the Wall Street Journal Online, October 7, 2008.

¹⁰ Dow Jones VentureSource.

¹¹ Russell Garland. "The Incredible Shrinking Venture-Capital Industry," Dow Jones VentureWire, June 19, 2008.

many poorer performing firms. The lack of exits in the short-term will divide the industry into firms with successful companies and those with companies that will not survive the downturn. Funds with poor track records will find it increasingly difficult to raise follow-on funds. Moreover, new funds with emerging managers will incur greater difficulties in raising first-time funds. The result will be greater consolidation in the venture industry with fewer active venture firms.

In addition, firm strategies will become more diverse. Already, we have seen venture firms investing in new geographies, a variety of investment stages and diverse industries. Investment opportunities have broadened beyond early-stage, U.S.-based telecommunications and IT companies and now include cleantech and life science companies, many of which are based in developing economies such as India and China.

There is no one recipe for expanding across stage, sector and geography.

Some firms have diversified internally within one fund, such as New Enterprise Associates; others, such as Sequoia Capital, raise separate funds for each strategy. Still other firms seek global partners (e.g., Draper Fisher Jurvetson), while their counterparts develop global expertise organically (e.g., Mayfield Fund). Venture capitalists' ability to adapt their strategy to the emerging opportunities will provide them with the resilience to succeed through the downturn and beyond. Given the expected attrition of venture firms, the industry will arguably have fewer players competing for a wider set of opportunities.

4. Venture capital performance will return to trend after the IPO window reopens

The credit crisis, the demise of leading investment banks, and general instability in capital markets have shut the window for IPOs. During the first quarter of 2008, only six venture-backed companies exited on U.S. exchanges and there were none in Q2 2008. At the time of writing, only two venture-backed companies, GT

Solar International [SOLR] and Rackspace Hosting [RAX] have gone public in the second half of 2008.

The biggest question facing the venture industry today is: When will the IPO market reopen and where—in the U.S., UK, United Arab Emirates or Asia? Without an active IPO market, venture returns would inevitably suffer. Exits will take longer, depressing IRR performance, and the big public offerings driving venture fund performance and boosting M&A valuations would be elusive.

Opinions differ about when IPO markets will return. A recent DLA Piper survey of technology executives, including company and venture leaders, indicated that more than half of the respondents believe that the IPO market in the U.S. will not begin to rebound until 2010.¹² The IPO research firm Renaissance Capital expects the worst case to be March 2009, based on their analysis of past IPO markets.¹³ At SVB Capital, our expectation is that public markets will most likely open in the next

¹² "DLA Piper 2008 technology leaders forecast survey reveals concerns and opportunities in the current economic environment," DLA Piper News, October 20, 2008.

¹³ "When will the IPO Market Return?" Renaissance Capital, October 2008.

nine to twelve months, but this timing is wholly dependent on the stability of the stock market, which in turn, is waiting for the reopening of credit markets and better economic news.

The IPO market is critical to the industry, and the National Venture Capital Association (NVCA), the trade association of the venture industry, has identified liquidity and exits as its first priority. This fall, the NVCA created blue ribbon committees — one of which includes SVB's Vice Chairman Harry Kellogg — to investigate the causes of the decline in venture-backed public offerings and submit recommendations to stimulate more IPO exits.

Once the exit markets return, a large number of strong venture-backed companies will be poised for IPO. We expect a Darwinian effect of the economic downturn, with the healthier companies surviving and becoming the leading companies of tomorrow. Likewise, returns should rebound. The pooled IRR of the top quartile venture funds over the last 20

years (Q3 1988 - Q2 2008) is 30 percent, and during the last five years (Q3 2003 - Q2 2008), during venture's recovery from the dotcom collapse, the pooled IRR for the top quartile funds fell to 18 percent.¹⁴ Based on historical trends and the current exit market, SVB Capital conservatively expects top quartile funds to return about 20 percent IRR over the next five years.

AN OPTIMISTIC AND MEASURED OUTLOOK FOR VENTURE

There are those who fear that the economic slowdown and financial turmoil will turn perceived fissures into deep cracks in the venture capital model. We at SVB Capital disagree. Most venture-backed companies are currently meeting financial targets. In addition, some dynamics in the market, such as consolidation of firms, will benefit the asset class. Finally, LP demand for venture investing will continue. As LP investors adapt their allocation strategies to market realities, venture investing will

look less risky relative to other asset classes.

SVB Capital recognizes potential risks current market conditions pose for venture capital, such as a prolonged volatility in financial markets, which will prevent exit opportunities, or reduced revenues earned by technology companies due to a stalled economy. On the whole, SVB Capital remains optimistic about the outlook for venture and is committed to identifying investment opportunities that generate top decile returns for investors.

¹⁴ IRR performance data from Thomson Reuters. The sample size for each period equals 316 funds.

This article contains forward looking statements and although these forward looking statements are based on the beliefs of, and assumptions made by, SVB Capital management and the various sources cited herein, such expectations may prove to be incorrect.

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TELL US WHAT YOU THINK

Send your comments and suggestions for topics to Bronwyn Dylla Bailey at bbailey@svb.com.

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