Back to the Future: Venture Capital Today

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Marty McFly: *[watching a Honeymooners episode in 1955]* Hey, hey, I've seen this one. I've seen this one. This is a classic. This is, uh, where Ralph dresses up as a man from space.
Milton Baines: What do you mean, you've seen this? It's brand new.
Marty McFly: Yeah, well, I saw it on a *[realizing]* ... rerun.
Milton Baines: What's a rerun?
Marty McFly: You'll find out.

-Scene from *Back to the Future*, 1985, Universal Pictures[1]

As investors survey the venture capital industry and note its returns over the past ten years, many are discouraged. Common sentiments are that returns have been poor and the venture capital model does not work. These ideas frequently appear in both general business journals and in tech-focused media outlets and could perhaps be called the "normal view" as they reflect conventional wisdom. *Forbes* has touted "Venture Capital's Coming Collapse,"[2] while the *Financial Times* screams that venture capital is "hit by excesses."[3] *BusinessWeek* believes that "fear of a shakeout is making for less venturesome capital."[4] Finally, *The Economist* notes that "institutional investors have been badly burnt putting money into new ventures over the past five years" and are "tempted to say good riddance."[5]

A common response to this sentiment is the decision to cease allocating capital to venture capital altogether. No investor can be faulted for thinking this way. Building a venture portfolio requires long periods of illiquidity, attempts to gain access to managers who are often closed, even now, to new investors, and the difficulty of evaluating track record information when comparables might be opaque or hard to come by.

Today is not the first time the industry has endured such negative sentiment and we set out to find a similar period when the validity of venture in its entirety came into question. The current period, including the Great Recession from 2007-2009 and the slow growth that has followed, was not caused by irrational exuberance surrounding technology, unlike the dot-com bubble of the late 1990s. Seeking a comparable period in venture's history therefore requires a look further back than the dot-com bubble. We find that the 1990-1991 US recession, with a corresponding decline in venture fundraising, is perhaps a useful case. **In fact, the first two of the four headlines above are from 2009, while the third and fourth are from 1991.**

Economic historians are still unclear as to what exactly caused the US recession lasting eight months from July of 1990 to early March of 1991. Notably, a technology bubble is not blamed.[6] Nonetheless, the venture capital industry saw a flight of capital and its existence and viability questioned. Taking a closer look at the two articles from 1991 above offers a reflection of the sentiment at the time. *Business Week*, in December of

1991, noted that “insiders blame the slump on the scores of iffy venture outfits that sprang up and threw money at virtually anyone spewing technobabble . . . while only a few of those firms have gone under, they‘ve generated disappointing returns for years.” *The Economist* was equally dour. “With so much money chasing so few true entrepreneurs, many bad projects received backing. Many good ones were so sought after that investors had to accept lower returns than they were used to.” At least *The Economist* attempted to end on a somewhat positive note: “Does all this portend another venture feast after the current famine? Possibly – but it is unlikely to be as lavish as in the past . . .”

Figure 1: Venture Capital Returns as of December 31, 1991[7]

Vintage	Top Quartile	
	Multiple	IRR
1982	1.6x	7.8%
1983	1.7x	10.4%
1984	1.4x	8.2%
1985	1.8x	13.7%
1986	1.4x	8.4%
1987	**1.1x**	**5.2%**
1988	**1.2x**	**8.4%**
1989	**1.0x**	**1.9%**
1990	**1.1x**	**6.1%**
1991	**1.0x**	**2.3%**

Seeing these headlines and looking at historic top-quartile performance data in 1991, an investor would have had good reason to be discouraged. When examining the data in Figure 1, a summary of VC returns as of December 31st, 1991, the headlines were more or less justified.

In response to the popular public narrative, capital committed to the venture capital industry declined during this period, from approximately $6.5B in 1989 to $5B in 1990 and then $3.5B in 1991, a total decline of about 46%.[8] The decline was large on a relative basis as well, as commitments to venture as a percentage of total stock market capitalization decreased from about .13% in 1987 to about .05% in 1991, a decline of 60%.[9] Finally, as the recession was reflected in public market volatility, IPOs declined too, from as many as 119 in 1987 to 67 in 1990.[10]

What if, despite all of the headwinds and negative sentiment, an investor had chosen to remain committed to the asset class? As time passed, the recession eased and public markets improved. Innovative technologies continued to attract capital and the resulting returns for the vintage years highlighted above and for the next several vintages were very rewarding, as seen in Figure 2.

Figure 2: Venture Capital Returns as of March 31, 2010[11]

Vintage	Top Quartile	
	Multiple	IRR
1982	1.8x	8.6%
1983	2.0x	9.4%
1984	2.0x	11.4%
1985	2.9x	15.3%
1986	2.0x	11.6%
1987	2.6x	17.4%
1988	2.6x	20.4%
1989	2.6x	19.2%
1990	2.9x	29.3%
1991	**3.4x**	**25.5%**
1992	**3.6x**	**38.9%**
1993	**2.8x**	**39.1%**
1994	**4.7x**	**42.1%**
1995	**4.2x**	**61.2%**

Imagine for a moment that the same investor in the example above had exited the asset class in 1991, only to attempt to re-enter in 1996. Having lost any access he may have had, the investor may have only been able to invest with second tier managers. While he may have had a year or two of good returns, he would then have suffered through the dot-com bust along with everyone else, after which he may have decided to exit the asset class yet again . . .

While we can certainly point to clear parallels between 1990-1991 and today in terms of capital flows, no historical analogy is perfect and there are many factors at work within the venture industry. Global innovation is subject to cycles which are distinct from capital formation cycles, and could be uncorrelated. Moreover, structural changes in the capital markets can have an impact on holding periods and the ease of an IPO, impacting returns for better or worse.

In summary, TrueBridge Capital Partners believes that venture capital, like any asset class, is susceptible to cycles. We also believe that it is very difficult to use market-timing techniques in one’s approach to venture investment. The very best managers are nearly always closed to new investors, through good times and bad. Should one seek to access them inconsistently, failure will more often than not be the result. Our strategy therefore is to consistently seek to underwrite and access the very best managers. Time has shown that those who pursue this strategy are well rewarded.

In examining the negative sentiment surrounding venture capital today, we are very excited about the current environment. Capital committed to the asset class has declined by about 74% from 2007 to 2010. Median early stage pre-money valuations are at a 20-year low for seed and Series A financings, both in nominal and inflation-adjusted terms. After nearly disappearing during the Great Recession, venture-backed IPOs have rebounded, from 6 in 2008, to 11 in 2009 and 43 YTD in 2010.[12] Venture commitments as a percentage of total stock market capitalization decreased from 0.19% in 2008 to 0.07% in 2009, or nearly 63%.[13]

Like Marty McFly, we have seen this show before. On the whole, the recent recession gives us particular optimism for recent vintage venture capital funds. The current decline in fundraising should help drive attractive returns for the next two to three vintage years. Disciplined investors who maintain their allocations will in all likelihood be satisfied with the results.

Endnotes

(1) *Back to the Future*, 1985. Universal Pictures.
(2) Buckman, Rebecca. 2009. "Venture Capital's Coming Collapse." *Forbes*, January 12.
(3) Waters, Richard and Joseph Menn. 2009. "Venture capital hit by excesses." *Financial Times*, April 20.
(4) Buderi, Robert, Gary McWilliams, and Joan O'C. Hamilton. 1991. "Even Hotshot Startups Are Feeling the Chill – Fear of a shakeout is making for less venturesome capital." *Business Week*, December 2.
(5) "Venture Capital: Plenty to Gain?" 1991. *The Economist*, December 7.
(6) Walsh, Carl E. 1993. "What Caused the 1990–1991 Recession?" *Economic Review* (Federal Reserve Bank of San Francisco).
(7) ThomsonOne (Venture Economics). Retrieved on November 8, 2010.
(8) Ibid.
(9) Estimated from Kaplan, Steven N. and Josh Lerner. 2010. "It Ain't Broke: The Past, Present, and Future of Venture Capital." *Journal of Applied Corporate Finance*, Vol. 22, No. 2, Spring.
(10) ThomsonOne (Venture Economics). Retrieved on November 8, 2010.
(11) Ibid.
(12) Ibid.
(13) Data from ThomsonOne (Venture Economics) and The World Bank. Retrieved on November 18, 2010.