Executive Summary

In our *State of the Venture Capital Industry* report last fall, we emphasized the difficulty in “timing” the asset class, since it is nearly impossible to access the best managers intermittently, and difficult to predict the best time to invest in seed and early stage companies that will achieve liquidity in five to ten years. At the same time, we suggested that for a number of reasons, now appears to be a better time to commit capital to the asset class than any point in the past 10 years (a self-serving exception, we must admit!). More time to digest the Great Recession’s specific impact on the venture capital industry, and a larger sample of relevant industry data have added substance to our argument.

Anecdotal news of fund size cuts among even reputable and established venture capital firms has abounded throughout 2009 and early-2010. So too have headlines like “VC Funds Called Off” for firms like Frazier Technology Ventures, Blueprint Ventures, and CenterPoint Venture Partners. Accordingly, we have read several stories of the number of venture professionals declining significantly – “not since the dot-com bust has the industry experienced as much turnover as it is now” led a 2009 *Wall Street Journal* story1. Full-year 2009 empirical data tells a similar story: VentureSource reported that U.S. venture capital fundraising fell from $29 billion in 2008 to $13 billion in 2009.

While these statistics may seem dour, we continue to believe they are positive for the industry for a number of reasons. Given its global nature, today’s venture industry can likely absorb $15-$20 billion effectively each year. As such, even if fundraising rebounds by 30% to 40% in 2010 (an aggressive assumption), we will remain comfortably within this range. Less capital and fewer active firms, with the stronger firms surviving, leads to lower valuations and more truly innovative companies receiving capital relative to “me too” businesses. And as a result, we believe returns over the next 10 years have the potential to be attractive relative to those of the past 10 years.

A peripheral conclusion is that the current industry contraction may be less severe but longer lasting than after the technology bubble burst in March 2000. Fundraising fell from $83 billion in 2000 to $10 billion in 2003 (a sharp decline). The following four years, fundraising increased by 80%, 52%, 10%, and 27%, reaching $40 billion in 2007 (a sharp rise). The industry experienced another steep decline last year, as fundraising fell 54% from 2008. However, we think the rebound could be more muted this time, in part because we have experienced a financial rather than technology crisis. But just as importantly, institutional investors are now realizing that the venture industry does not scale well, and understand the merits of a concentrated portfolio comprised of the very best managers in the business, provided you are able to access these managers. Today, there are 366 firms we consider *truly active* – those that completed at least three financings in 2009 – down from 678 in 2000 and 470 in 2005. We think current sentiment among limited partners should keep this number in a more desirable 300-450 range.

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Fundraising

Venture capital fundraising fell significantly in 2009 from 2008 and 2007 levels. According to VentureSource, the amount of seed and early stage capital raised by venture capital managers in the U.S. in 2009 was $5.4 billion, which is 50% less than the $10.8 billion raised in 2008, and 62% less than the $14.1 billion raised in 2007. To quantify fundraising by the number of firms raising capital, which affects the structure of the market, 75 firms raised seed and early stage funds in 2009, 36% less than the 118 firms that did so in 2008, and 40% less than the 124 firms that did so in 2007.

Fundraising data including later and multi stage financings, in addition to the seed and early stage data, tells a similar story. VentureSource reported that the total amount of capital (all stages) raised by venture capital managers in the U.S. in 2009 was $13.3 billion, which is 54% less than the $29.2 billion raised in 2008, and 67% less than the $40.0 billion raised in 2007. The total number of firms that raised venture capital funds in 2009 was 130, 37% less than the 206 firms that did so in 2008, and 40% less than the 215 firms that did so in 2007.

Exhibit 1 – Venture capital fundraising has fallen significantly since the bubble

Source: VentureSource data through December 31, 2009
Includes fundraising by venture capital and venture capital-type investors (funds with limited partners)
As in previous communications, Exhibit 2 below defines and estimates the number of active firms in the venture market over time, a somewhat esoteric measure due to the long-tailed nature of venture capital funds. We analyze both the number of firms that raised capital in the current and previous four vintage years, as well as the number of firms that have invested in one, three, and five companies each year. The first method acts as a proxy for investable capital, as venture capital investment periods typically span five years. After the investment period, uninvested capital is rarely used for new seed and early stage deals and therefore does not affect early stage valuations. Per this method, Exhibit 2 indicates that there are roughly 680 active firms today, or 47% fewer than in 2001, the height of the Internet bubble. To pare this back to what we perceive as truly active firms, only 366 managers completed at least three financings in 2009 (a conservative measure of truly active firms, in our view). This is 46% fewer firms than the 678 that completed at least three deals in 2000. While some “overhang,” or uninvested capital certainly persists, we are trending toward what we and our managers perceive as a “right-sized” industry.

**Exhibit 2 – Measured industry contraction since the bubble, but we’re getting there**

**Active Venture Capital Funds by Deals**

Our anecdotal experience in the past six to nine months has been that the most experienced institutional investors – those that have invested across several market cycles and have been able to consistently access the very best venture capital managers – are concentrating their number of venture capital relationships. This is due both to a continued focus on liquidity, as well as an increasing belief that only the best venture capital managers are likely to generate superior risk-adjusted rates of return. As a result of this “flight to quality,” top-tier managers like August Capital, Redpoint Ventures, and Battery Ventures have been materially oversubscribed by their existing investors throughout the financial crisis, while secondary and tertiary managers have struggled to raise even nominal amounts of capital. We continue to invest with a similar belief that a relatively concentrated portfolio of venture managers is ideal, provided you have the experience and relationships to identify and invest with the very best managers in the business.

We continue to believe that the ongoing contraction in the venture capital industry is positive for the firms that remain in the asset class. The general market turmoil of 2008-2009 accelerated the contraction, but the process had already begun due to low absolute

Source: Venture Economics (funds) and VentureSource (deals); U.S.-only independent private partnerships
Aggregate funds include all U.S. venture capital funds that raised capital in the current and previous four vintage years
returns during the past eight to ten years (which in turn were partially a result of a glut of capital and market participants, as well as an extended period of low absolute public equity market returns). While the industry maintains a critical mass – particularly in geographies like Silicon Valley and Boston, MA – fewer firms are now making new investments, which should reduce competition, drive down pricing, and set the stage for attractive returns over the next cycle.

Investments

According to VentureSource, $3.9 billion was invested by venture capital managers in seed and early stage portfolio companies in the U.S. in 2009, which is 41% less than the $6.6 billion invested in 2008, and 49% less than the $7.7 billion invested in 2007. The number of seed and early stage financings in 2009 was 847, 25% less than the 1,136 financings in 2008, and 30% less than the 1,209 financings in 2007.

Investment data including later and multi stage financings, in addition to the seed and early stage data, also mirrors the fundraising story. The total amount invested by venture capital managers (all stages) in U.S.-based portfolio companies in 2009 was $21.4 billion, which is 29% less than the $30.4 billion invested in 2008, and 32% less than the $31.4 billion invested in 2007. The number of total U.S. venture capital financings in 2009 was 2,494, 9% less than the 2,741 financings in 2008, and 12% less than the 2,846 financings in 2007.

Exhibit 3 – Investing follows fundraising – fewer financings, less capital deployed

Seed/Early Stage Capital Invested
Discussions with our managers throughout 2009 prepared us for the steep decline in investment activity. Several managers indicated they saw more deals than ever before in 2009, but the quality was poor and buyer-seller price discrepancy persisted due to market uncertainty. Anecdotally, and within our portfolio, the early part of 2010 has seen a pickup in investment activity off of 2009 levels as investors gained confidence in macroeconomic and company-specific forecasts. Still, we believe that reduced fundraising activity will persist and cap investment activity for the foreseeable future.

As mentioned in our last report, we believe that fewer firms making investments in an industry with less capital overall leads to more truly innovative companies receiving funding relative to “me too” businesses. We also mentioned our managers’ feedback that the post-financial crisis environment has allowed more time to diligence each deal; we believe this continues in most cases, though “hot” deals like Groupon, Twitter, Facebook, and some in the “location-based services” space (including Gowalla and Foursquare) have seen top-tier venture capital firms circling for access at escalated valuations (although we cannot yet comment whether prices paid represent good value – Accel’s initial investment in Facebook at a $100 million valuation seems like far better value today than in 2005, given the recent $8-$15 billion valuations). For the most part, the current environment is allowing more diligence and discipline as managers underwrite new venture capital investments.

With regard to specific sectors, healthcare composed 38% of the total venture capital dollars invested in 2009 according to VentureSource, relative to 30% for information technology (“IT”). This compared to healthcare composing 30%, and IT 32%, of the 2008 total. The amount of capital deployed into each sector declined as overall investment activity fell significantly from 2008 to 2009, although the relative allocation to healthcare increased. We believe the general market allocation between healthcare and IT highlights our portfolio’s overweighting of IT relative to life sciences, to which we adhere given the shorter time horizon, capital efficiency, and high historical returns of IT investments relative to life sciences investments. Also of note, for all of the press that clean energy
investments receive, the space has never composed greater than 12% of total venture capital investments by dollars (and no greater than 4% of investments by number or deals). We continue to be cautiously optimistic about clean energy, and while we have not committed to a clean energy-dedicated fund to date, we have significant exposure to the sector through our diversified managers.

**Valuations**

Median early stage pre-money valuations remained low – below $5 million – for each quarter of 2009. Exhibit 4 shows the annual median pre-money valuation reaching $4.6 million in 2009, the lowest point since 2003 and the fourth-lowest annual median in the past 20 years in nominal terms. In real, or inflation-adjusted terms, today's median valuation is likely the lowest in the past 20 years.

**Exhibit 4 – Annual median valuations at lowest point since 2003, but still within range**

The chart above indicates the grain of salt with which this data point should be taken, however, as median early stage valuations have traded in a range between $4-$6 million since 2002 (and $4.6 million is squarely within this range). Today therefore appears to be an only slightly more favorable environment in which to invest capital on a pure valuation basis (although we should point-out that 2009’s median valuation in fact represents a 31% discount to that of 2007). We think the chart emphasizes the importance of recognizing frenzied periods like 2000 – a vintage year among the venture capital industry’s poorest performers, surely correlated to the period’s valuations reaching $11.3 million. But perhaps more saliently, valuations are declining while the quality of the average company receiving funding is increasing. Because of an improving industry structure with less capital and fewer venture firms, fewer investments are being made now than at any point in the past 10 years, driving valuations downward. Less capital also means a higher bar for venture firms making new investments, which now tend to be more innovative and not copycats. Because companies funded today are of higher quality, they should have a correspondingly higher pre-money valuation. But the industry’s improving structure has kept valuations of these better businesses low. We believe valuations could trend slightly upward over the next 24-48 months while still representing good value.
Exits

One of the poorest periods in history for venture-backed liquidity continued in 2009. Just 11 U.S.-based venture-backed companies achieved initial public offerings (“IPOs”) in the year, an uptick from the six IPOs in 2008 but off 86% from the 80 IPOs in 2007. In fact, the 17 total IPOs in 2008 and 2009 is lower than any other single year’s total since at least 1994. Mergers and acquisitions (“M&A”) activity has remained more constant over time and has thus composed a larger portion of total exits in the past few years as IPOs decreased. Still, M&A activity fell in 2009, as the 271 venture-backed companies acquired was a 23% decline from 2008. Evident in Exhibit 5, the bar to achieve liquidity, and particularly an IPO, is far higher today than most points in recent history. Through the crisis, public market investors have become increasingly risk averse, and are generally unwilling to invest in fast-growing companies below certain market capitalizations (currently $350-$400 million). This leads to longer time to liquidity, as it takes a longer time for venture capitalists to build companies to significant scale. Encouragingly, the median time from initial equity funding to M&A exit decreased from six to five years from 2008 to 2009 according to VentureSource. In turn, the median time from initial equity funding to IPO decreased from nine to eight years over the same period. Taken with another grain of salt, this data may be less a sign of a trend reversal and more an indication that since so few companies achieved liquidity in 2009, the sample is not statistically significant. Venture capital remains a long-term asset class, and one in which it takes significant time (typically 4-10 years) to build real value from the early stage. So, we do not expect a return to the median of three years to IPO seen by companies that achieved liquidity in 1999 and 2000. But we do believe that with less total capital in the industry, fewer active venture capital firms, and a return to some normalcy in the IPO market (perhaps 40-80 IPOs per year), the exits that do occur will be more impactful to each fund and allow stronger industry returns.

Exhibit 5 – Exit market showing some signs of life but still unprecedentedly weak
Exhibit 5 (cont’d) – Exit market showing some signs of life but still unprecedentedly weak

Venture-backed M&A and Deal Value

![Graph showing Venture-backed M&A and Deal Value](source: Venture Economics; U.S.-only, venture-backed companies *2010 data through March 31, 2010)

The IPO market is beginning to show signs of a return to normalcy, with the 12 U.S.-based venture-backed IPOs to date in 2010 having already surpassed 2009’s total. The pipeline for future venture-backed IPOs appears fairly robust, with 45 companies currently in registration. And, if investors’ appetite for IPOs is influenced by post-IPO performance, they should be encouraged by the 21% capitalization-weighted rise of this year’s IPOs to date, shown in Exhibit 6 below, compared to a 9% rise in the S&P 500 over the same period.

Exhibit 6 – Strong performance of recent IPOs could pave way for future success

2010 U.S.-based venture-backed IPOs’ performance post-IPO

![Graph showing 2010 U.S.-based venture-backed IPOs’ performance post-IPO](source: Venture Economics and Yahoo! Finance U.S.-only, venture-backed companies; data as of April 21, 2010)

A final interesting note about venture liquidity: despite the headline attention given to the IPO market, M&A remains the likely liquidity route for venture-backed companies (shown in Exhibit 7), as has been the case for the vast majority of the past 15 years. We believe this will continue, and that positive tailwinds exist for companies seeking acquisition. Large technology companies like Google, Microsoft, and Cisco have significant cash
balances and have voiced intentions to acquire innovative venture-backed companies to fuel future growth. Google has been particularly active in both words and action. In September 2009, CEO Eric Schmidt said the company plans to acquire one company per month in lieu of new hiring, and true to his word, the company has acquired five venture-backed companies since November 2009.

**Exhibit 7 – M&A dramatically outnumbers IPOs (and has since 2000)**

![Venture-backed M&A versus IPOs by Number](chart)

Source: Venture Economics as of March 31, 2010  
U.S.-only, venture-backed companies

**Conclusion**

Institutional investors continue to closely monitor their liquidity situations, and at the same time are realizing that the venture industry does not scale well. Investors also recognize the merits of a concentrated venture capital portfolio, provided you are able to access the best managers. These factors combined to significantly reduce demand for venture capital in 2009 and the early part of 2010, and caused steep fundraising declines. While liquidity situations are improving, we expect limited partners to increasingly concentrate their venture capital portfolios. As a result, we expect venture fundraising to rebound less sharply than after the technology bubble burst 10 years ago.

While innovation continues and our managers are increasingly excited about IT sectors like mobile, cloud computing, clean energy, and consumer internet, venture investments declined significantly in 2009 as well. Due to less capital flows into the industry, we expect investment levels to remain below 2005-2008 (and certainly below 1999-2000) levels.

Following fundraising and investment declines, early stage pre-money valuations fell to the low end of the market’s eight-year range. We actually believe valuations could increase over the next 24-48 months while still representing good value.

The continued weakness in exit markets – particularly for IPOs – is a clear concern for the venture industry. A stronger, if not robust, liquidity market must return to create a truly compelling venture capital ecosystem. But bright spots do exist for both IPOs and M&A, and combined with the venture industry’s “right-sizing” by capital and number of firms, we continue to believe dollars invested today are well positioned for attractive returns over the next 10 years.