Executive Summary

Much has changed since our 2010 *State of the Venture Capital Industry* report. Last year, headlines about venture firms shuttering, poor recent industry returns, and venture capitalists exiting the industry abounded. Shift to early-2011, and talk of another venture capital bubble has taken the place of malaise. To avoid bold predictions, we will largely stray from the bubble debate (while mentioning that this time feels different). Instead, this report once again blocks and tackles, examining industry trends around four key areas: fundraising, investments, valuations, and exits.

Venture capital fundraising continued its downward trend in 2010. Forty-six percent less seed and early stage capital was raised, and 21% less total venture capital (all stages) was raised in 2010 relative to 2009. From a fundraising standpoint, the industry seems to have found its footing in this cycle, such that firms that have shown results have raised capital quickly, while firms with less stellar track records have struggled mightily. In a “haves and have-nots” world, capital is concentrating in the hands of the very best investors.

Investment activity actually ticked up slightly in 2010 relative to 2009, but 2009 was an abnormally slow year amidst widespread buyer-seller price discrepancy. Investment activity remains near its lowest point in the past 10 years, and the $23.4 billion invested last year is 75% less than the amount invested in 2000, the peak of the dotcom era. Given fundraising declines and continued aversion by limited partners of firms without top-tier track records, we do not see investment activity rising significantly any time soon.

Paralleling fundraising and investment declines, competition is less fierce and valuations are also, on average, near low points. Some segments – namely, late stage and Internet – seem expensive, but on the whole the venture ecosystem is once again virtuous in that fewer firms are competing for deals, only the best companies are able to raise capital, valuations are typically reasonable, and less competition exists at the portfolio company level once a company does receive funding, allowing businesses to scale more quickly.

The last piece of the puzzle, the exit market, has begun to show signs of life – albeit off a very low base. Last year, 47 U.S.-based venture-backed companies went public, 327% more than in 2009, while M&A activity also increased significantly. Eighteen venture-backed companies have gone public to date in 2011, including LinkedIn – classified by many as the first in a wave of “hot” social networking IPOs – which performed well subsequently, perhaps paving the way for the rest of the wave, as well as other companies, to follow suit. We would ideally like to see 70-80 venture-backed IPOs annually to create a truly robust venture environment. All things considered, however, we continue to believe that capital committed to the venture capital asset class today should be well positioned to earn attractive returns going forward.

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(1) As of May 25, 2011
**Fundraising**

Venture capital fundraising continued its downward trend in 2010. According to Thomson One, 73 funds raised $4.7 billion of seed and early stage capital in the U.S. in 2010, down from the 78 funds that raised $8.6 billion in 2009. This represents a 46% year-over-year decline in capital raised. As an even starker contrast to 2010, 116 firms raised $12.0 billion of seed and early stage capital in 2008. And in 2000, referred to by many as the peak of the dotcom bubble, 292 firms raised $45.3 billion. The clear indication from the data is that fewer firms are active in the venture capital industry, and each fund is raising less capital on average, than at most points during the past 10 years. The median amount of seed and early stage capital raised in each year since 2003 – when fundraising began to rebound after the dotcom era – was $9.3 billion. This level of annual fundraising is roughly 50% below the median of $20.2 billion raised each year between 1997 and 2001, and has significantly improved the dynamics between the supply of and demand for capital.

Fundraising data including all venture capital, inclusive of seed, early, later, and multi stage capital, tells a similar story. The total amount of capital (all stages) raised by venture capital managers in the U.S. in 2010 was $11.2 billion, which is 21% less than the $14.1 billion raised in 2009, and 54% less than the $24.6 billion raised in 2008. Fundraising across all stages of venture capital clearly continued its decline, but at a more moderate pace than in prior years, indicating that fundraising is beginning to bottom. The total number of firms that raised venture capital funds in 2010 was 125, just 5% less than the 132 firms that did so in 2009, but 34% less than the 190 firms that did so in 2008. Once again, the statistics in relation to the peak of the dotcom bubble are remarkable. Four hundred eighty-two funds raised $83.9 billion of capital in 2000 – most of which has likely (finally) worked itself out of the industry based on typical five-year investment periods and five-year follow-on time horizons – and is therefore no longer driving up valuations.

**Exhibit 1 – Fundraising continues its decline, but at a more measured pace**

![Graph showing trend in seed/early stage fundraising from 2000 to 2010](image)

Source: Thomson One as of December 31, 2010

Includes fundraising by U.S. venture capital and venture capital-type investors (funds with limited partners)
Exhibit 1 (cont’d) – Fundraising continues its decline, but at a more measured pace

More than $6 billion of venture capital has been raised in the U.S. 2011 through May 25 according to Thomson One, or close to $15 billion on an annualized basis. However, it is our sense that fundraising in 2011 is at least slightly front end-loaded – with firms such as Bessemer Venture Partners and Kleiner Perkins having closed large pools of capital – and that the full-year number will be south of $15 billion and perhaps just a slight increase over the $11.2 billion raised in 2010.

A clear trend in the fundraising market has been a concentration of capital with the very best firms – those that have been able to generate attractive returns and distribute capital to limited partners, even during difficult periods such as the past ten years. In our last report, we termed this phenomenon a “flight to quality.” Since then, Andreessen Horowitz, co-founded by Netscape and Opsware founder Marc Andreessen and which recently sold its $65 million stake in Skype to Microsoft for more than $200 million in less than 18 months, raised $850 million to pursue multi stage venture capital investing. Sequoia Capital and Kleiner Perkins, both widely regarded as elite venture capital firms, each recently raised large pools of capital quickly. And Accel Partners, the first institutional backer of Facebook and an early investor in Groupon, is quickly rounding out heavily oversubscribed fundraisings for four of its funds. Firms with less stellar recent track records – even those with strong brand names historically, have been less fortunate. Highland Capital raised just $400 million for its eighth fund, 50% less than its $800 million predecessor, and Polaris Ventures raised $375 million for its sixth fund, a 65% cut from its fifth fund. Many other firms have been unable to raise any capital in the current cycle. The result is that the majority of capital is shifting toward the most capable investors. Entrepreneurs who receive capital from these managers, and limited partners in top managers’ funds, should be the beneficiaries in the current investment cycle.

As in previous State of the Venture Capital Industry reports, Exhibit 2 estimates the number of active firms in the venture capital market over time. 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 at least five companies each year. The first method – depicted by the dark blue bars – proxies the number of firms with investable capital, as venture capital investment periods typically span five years. After the
investment period, un-invested capital is rarely used for new seed and early stage deals and therefore does not affect seed and early stage valuations. Per this method, Exhibit 2 indicates that there are roughly 591 firms within their investment period today, or 52% fewer than in 2001, the peak of the data set. To pare this back to what we perceive as truly active firms, just 279 managers completed at least five new or follow-on financings in 2010. Given that for some of these firms, all five investments may have been follow-on investments from legacy funds, the real number of active firms may be even lower. The number of truly active firms in 2010 is 48% fewer than the 533 firms that completed at least five deals in 2000. We continue to believe that the industry is “right-sizing,” and that the number of firms today creates a compelling environment with reasonable valuations and healthy competition at both the venture capital- and portfolio company-level.

Exhibit 2 – Venture capital industry continues to “right-size”

![Number of Funds/Firms over Time](chart)

Source: Thomson One (funds) and VentureSource (deals); U.S.-only independent private partnerships

Aggregate funds includes all U.S. venture capital funds that raised capital in the current and previous four vintage years

A final note about fundraising: the trend, perhaps most recognizable in the press and industry participants’ mind share, has been towards a barbell strategy. That is, fervor around seed and growth / late stage investing and fundraising, while enthusiasm has lacked for the early and mid stages. Several top managers – notably Accel Partners, Andreessen Horowitz, Greylock Partners, and Kleiner Perkins – have raised or are raising pools of capital dedicated to the growth or late stage venture capital space in the past nine months. These funds have since capitalized on what they believe have been attractive valuations for companies such as Facebook, Twitter, Groupon, Zynga, and Spotify, as well as bootstrapped companies, typically with revenues between $10 and $50 million. At the same time, these managers have developed strategies or ramped up activity at the seed stage. These firms often view seed investments as “options” on future financings. They are able to write small checks relative to their overall fund size for a large percentage of a seed stage company, then retain the ability to support the company further if it takes off. Additionally, several “Super Angel” managers have recently raised sub-$75 million funds to target the seed space by making small – typically less than $1 million – initial investments in consumer web startups. These activities and their implications will be discussed further in the Investments and Valuations sections.
Investments

Thomson One precludes direct comparisons between fundraising and investments data, since venture capital investments data also includes those by corporate and other entities, while fundraising data enables analysis of purely institutional venture capital fundraising. True capital invested by institutional venture capital firms is likely lower than the statistics captured below, but we believe the data to be directionally accurate.

In contrast to fundraising, venture capital investments actually ticked up in 2010. According to Thomson One, $7.1 billion was invested in seed and early stage portfolio companies in the U.S. in 2010, 11% more than the $6.4 billion invested in 2009, but roughly the same as the $7.0 billion invested in 2008. The number of seed and early stage companies that received capital in 2010 was 1,309, 20% more than the 1,088 companies that did so in 2009, but 5% less than the 2008 number.

Similarly, when considering later and multi stage financings in addition to those at the seed and early stage, activity picked up in 2010. In 2010, $23.4 billion was invested in 2,873 companies, compared to $19.9 billion invested in 2,579 companies in 2009. But once again, relative to 2008, activity curtailed. Twenty percent fewer companies received 16% less capital in 2010 relative to 2008. The recent fluctuations in investment activity pale in comparison to the longer-term trend, however. In 2000, 3,084 seed and early stage companies received $26.6 billion of capital, and across all stages, 6,379 companies received $100 billion of capital. We think it is safe to say that from an investment activity level perspective, many of the comparisons of today to the dotcom bubble are unfounded. Far fewer companies are being funded, leading to less competition at both the venture capital level, where valuations have fallen, and the portfolio company level, where companies can gain traction and market share more easily.

As mentioned in our last report, managers indicated throughout 2009 and the early part of 2010 that the quality of companies seeking funding was poor and market uncertainty created buyer-seller price discrepancy. We were therefore not surprised to see general venture capital investment activity pickup in 2010 as stability returned to the broader market and quality to the venture capital market.

Exhibit 3 – Investment activity ticks up slightly, but off a low 2009

Source: Thomson One data through December 31, 2010
Much has been made lately of the aforementioned “Super Angel” phenomenon that has swept Silicon Valley. Former executives at successful technology companies such as Google, Facebook, eBay, and PayPal have built successful – albeit short – investment track records by investing personal capital in companies at the seed stage. Several of these investors recently raised small institutional funds, typically less than $75 million, to continue this strategy. 500 Startups, Felicis Ventures, FLOODGATE, IA Ventures, and SoftTech VC are all firms that have raised funds in the past 18 months or are currently raising capital to invest at the seed stage. The rise of seed is driven primarily by two phenomena: first, many other successful operators have become newly wealthy due to the success of Google, Facebook, Twitter, and other prominent venture-backed companies – providing them with capital to make small, risky “angel” investments in technology ideas; second, the cost to start consumer web-focused businesses has decreased dramatically in recent years, allowing companies to effectively prove their products on far less initial capital. If these products are subsequently proven, Super Angels’ investments are often written-up significantly or acquired for an attractive investment multiple. As shown in Exhibit 4, seed investment activity rose in each year since 2003, reaching a plateau in 2009 and 2010. While seed stage valuations have not risen across the board, anecdotes abound about entrepreneurs with little more than an interesting idea raising capital at pre-money valuations greater $10 million. Further, many more seed stage businesses have received funding recently than probably should have. The result will likely be an abundance of companies seeking to raise Series A and B – early to mid stage – capital over the next 18 months. The glut of seed-backed companies should lead to a decline in the general price level at the early stage, but hopefully also to an increase in the number of interesting projects in which early stage-focused venture capital firms can invest.
Congruent with the rise in interest in the seed space, many historically early stage venture capital firms have recently expanded their product offerings to enable later stage investments, which for several reasons have also come into vogue. One reason is that companies have chosen to remain private longer than in the past given the demands imposed on public companies. A second reason is the realization by venture capital firms that technology markets have become increasingly global in the past ten years, and significant capital is necessary to address these opportunities. Regardless of the reason, the result is the same: venture capital firms are beginning to capture most of the financial gain from companies’ expansion previously afforded to public market investors. Accel Partners invested in Groupon’s initial expansion round from its first Growth Fund, which the firm raised in late-2009, and the company has grown 15-fold since. Many venture capital investors have provided capital beyond the Series A and B rounds to Facebook, and have captured its rise to a valuation above $50 billion. And beyond these and other big name venture-backed companies – including Twitter, Zynga, and LinkedIn – there are plenty of lesser known companies that are expanding rapidly and need capital to finance this grown. As mentioned previously, most top venture capital firms – including Accel Partners, Andreessen Horowitz, Greylock Partners, Kleiner Perkins, Redpoint Ventures, and Sequoia Capital – have products focused toward the growth and later stage venture spaces. This is in addition to firms such as IVP and Meritech that focus exclusively on growth and later stage venture capital. Plenty of opportunities exist, but the market is becoming increasingly competitive. Interestingly, the data does not necessarily support the anecdotes. As shown in Exhibit 5, both the amount of capital and number of companies receiving late stage capital fell in 2009 and 2010 relative to 2007 and 2008. The likely reason is that while top venture capital firms have successfully raised and deployed capital at the late stage, it is not filling the void left by small- and medium-sized buyout fund investors and hedge funds that historically focused on the late stage market.
Exhibit 5 – Surprisingly, late stage investment activity has fallen in the past two years

Source: Thomson One data through December 31, 2010

Valuations

Despite the attention given to seed stage investing recently, median seed stage pre-money valuations have remained relatively flat over the past 10 years after falling more than 50% between 2000 and 2001. Between 2009 and 2010, seed stage valuations rose just 3%. Increased capital efficiency – particularly among Internet startups – may be driving the divergence between enthusiasm and pricing. Today, Internet companies can be developed and distributed quickly and at a low cost. Capital efficiency leads more entrepreneurs to start companies, thus increasing the supply and decreasing the valuations of investable ideas. Not surprisingly given investors’ focus on seed and later stage investing recently, early stage valuations fell last year to their lowest point since 2005. In fact, on an inflation-adjusted basis, early stage valuations are near their lowest point in the past 20 years. As mentioned previously, early stage valuations may continue to fall given the glut of seed stage companies likely to seek early stage financings over the next 18 months.

Exhibit 6 – Seed valuations largely unchanged, while early stage valuations have fallen

Source: VentureSource through December 31, 2010
Seed and early stage, U.S. and Europe-based deals only
Similar to early stage valuations, mid stage valuations declined recently, having fallen 43% from 2008 to 2010. Late stage valuations – driven in part by the frenzy around several hot, mostly consumer-oriented, technology companies – have risen dramatically. From 2003 through 2010, late stage valuations rose approximately 190%. Valuations seem frothy, at least relative to a few years ago, but LinkedIn, a social networking website for professionals, has shown through its May 19 IPO and subsequent 109% rise on its first trading day that upside may still remain after these businesses go public. A caveat to the recent price appreciation at the late stage is that as mentioned earlier, many companies have remained private longer than historically (either by choice or necessity). The median company age at IPO in 2005 was 6.4 years, while for the 18 businesses that have gone public in 2011, the median age was 10.2 years. As companies remain private longer, their financial metrics have more time to mature. It is therefore feasible that while today’s valuations are higher, they are justified given improved underlying fundamentals.

Exhibit 7 – Seed valuations largely unchanged, while early stage valuations have fallen

![Median Seed and Early Stage Pre-Money Valuations](image)

Source: VentureSource through December 31, 2010
Seed and early stage, U.S. and Europe-based deals only

Of note, valuations have varied even more dramatically by sector than stage. Comparisons between today and the late-1990s abound given the seemingly rich valuations for select companies. However, evidenced in Exhibit 7, only in the Internet sector have prices risen in the past year, while in all others, pre-money valuations have declined significantly. Communications and media prices fell by 20%, while prices in semiconductors and hardware fell by 77%, and 93%, respectively. The three- and five-year pricing trends in software are up, but the trend reversed last year as prices fell by 39%. So while irrational exuberance may influence some pockets of the market, the broader pricing trend in venture capital is certainly downward.

Exhibit 7 – Internet is hot, but all other sectors have seen significant pricing pressure

<table>
<thead>
<tr>
<th></th>
<th>Internet</th>
<th>Software</th>
<th>Comm./Media</th>
<th>Semis</th>
<th>Hardware</th>
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<td>5-year</td>
<td>23%</td>
<td>6%</td>
<td>(11%)</td>
<td>(0%)</td>
<td>(21%)</td>
</tr>
<tr>
<td>3-year</td>
<td>30%</td>
<td>28%</td>
<td>(48%)</td>
<td>(2%)</td>
<td>(18%)</td>
</tr>
<tr>
<td>1-year</td>
<td>88%</td>
<td>(39%)</td>
<td>(20%)</td>
<td>(77%)</td>
<td>(93%)</td>
</tr>
</tbody>
</table>

Source: Thomson One through December 31, 2010
All stages, U.S.-based deals only
Now seems an opportune time for firms to increase their activity at the early and mid stages, while caution may be necessary at the late stage. Here, investors must use discretion to only pay the going valuations when justified by world class management teams and large market opportunities. Also, venture capital firms should tread lightly in overpriced sectors – namely, Internet – unless company and market fundamentals and potential truly justify the valuation.

**Exits**

In our last report, we chronicled one of the poorest periods in history for venture-backed liquidity. Just 11 U.S.-based venture-backed companies achieved initial public offerings (“IPOs”) 2009, while only six did so in 2008. The median number of annual venture-backed IPOs from 1995-2000 was 222. While that level of public market liquidity is likely an anomaly, liquidity from 2001-2009, when the median number of annual IPOs was just 37, was likely so as well. We would prefer a return to the median of 79 venture-backed IPOs per year over the entire 15-year data set from 1995-2009. Markets have begun to trend in the right direction in 2010 and the early part of 2011. Forty-seven U.S.-based venture-backed companies achieved liquidity in 2010, and 18 – or 43 on an annualized basis – have done so through May 25, 2011. One venture manager in our portfolio said recently that his firm has 20 companies with metrics similar to or better than those that went public in the preceding 12 months, and given public market appetite for growth, the firm is encouraging each of these companies to pursue near-term IPOs. His message was that they have seen periods of strong demand for small, fast growing venture-backed companies before, which typically span 18-48 months, and his firm wants to capitalize on the current window. The median post-IPO market capitalization for venture-backed companies has remained high. In 2010, the metric stood at $305 million, and to date in 2011, the median has been $363 million. Annual revenues greater than $100 million persists as the general benchmark before venture-backed companies can generate public market interest. Encouragingly, however, we have recently seen several examples – including Cornerstone OnDemand, Responsys, and RPX – of companies going public at revenues below $100 million, leading us to believe that interest is returning for smaller, and perhaps higher growth, companies.

Mergers and acquisitions (“M&A”) activity picked up significantly in 2010. Four hundred thirty-five venture-backed businesses were acquired last year, a 60% increase from the 2009 doldrums. M&A activity did not suffer the same decline after the dotcom bubble as IPO activity, although acquisition values – which are typically driven by public market comparables and the flexibility for companies to either go public or be acquired – bottomed from 2001-2004. Last year, the average acquisition price rose by 7% over 2009 to $145 million, continuing its upward trend since 2002. One hundred fifty-two – or 365 on an annualized basis – companies have been acquired to date in 2011. Given companies’ current option to go public, as well as the significant cash balances of large potential acquirers such as Google, Apple, and Facebook, we expect acquisition values to continue to rise and M&A activity to remain constant or increase over the next year.
Exhibit 5 – Exit market showing signs of life, but improvement still needed

Venture-backed IPOs and Market Value

Venture-backed M&A and Deal Value

Source: Thomson One through December 31, 2010; U.S.-based, venture-backed companies

Conclusion

We have come through the depths of the financial crisis, which in conjunction with poor absolute returns in the venture industry over the past 10 years, impacted fundraising and other aspects of the venture capital market. Fundraising continued its decline in 2010, albeit at a more measured pace. We continue to expect, as noted in our last report, that when fundraising does rebound, it will do so less sharply than after the dotcom bubble burst. Investment activity rebounded slightly in 2010, but only off an abnormally low 2009. Fundraising and investment declines have created a far more attractive and less competitive venture capital environment. To this end, valuations fell nearly across the board, save for at the late stage and in the Internet sector, where valuations rose for reasons stated previously. The exit market continued to show signs of life, and the forthcoming IPOs of several high profile companies should allow this positive trend to continue. Our core tenet – that it is difficult to time the venture capital market and the best managers will consistently outperform public markets – notwithstanding, now may be a better time than most points in the past 10 years to commit capital to the venture asset class, with capital committed today well positioned to earn attractive returns.