RED HERRING

BACK TO 1990

BY JULIE LANDRY

TOP TEN TRENDS 2003

VENTURE CAPITAL

THE COMING YEAR WILL LOOK LIKE 1990, WITH JUST 50 FUNDS RAISING $2.5 BILLION, OR LESS THAN 5 PERCENT OF WHAT THEY RAISED IN 2000. BUT GUESS WHAT? THERE WON'T BE A SHAKEOUT IN VENTURE CAPITAL. THAT SAID, PITY THE LATE-STAGE COMPANIES.

WHY IT WILL (WON'T) HAPPEN

Hold that schadenfreude—2003 won't see scores of venture capital firms closing their doors or returning the piles of cash they're sitting on. The bulk of money raised during the bubble came from strong, established firms, rather than new, weaker ones. These established VC firms existed before the boom and will still be around after the bust. Even struggling firms need only one deal that hits it big to return something—or at least break even—on a fund. Plus, the unwinding of a VC firm happens gradually, if it happens at all.

Between 1996 and 2001, the number of VC firms in the United States jumped from 422 to 669 (see "Ventures Gained," page 38). And by design, venture funds are tougher to kill than the Wicked Witch of the West—no amount of cold water will make them melt away. When a new fund is raised, it has seven to ten years to make investments, exit those investments, and distribute the profits to its limited partners (LPs). So, at least in theory, a firm that started in, say, 1999 will be around until 2006. VCs can survive because every firm, no matter how bad, collects a healthy fee to manage its funds—generally around 2 percent of the fund's dollar value.

Still, in 2002, at least a dozen top-tier firms, including Atlas Venture; Charles River Ventures; and Mohr, Davidow Ventures, cut the size of their most recent funds, each of which had hovered around $1 billion. They returned several billion dollars in committed capital to LPs and often laid off partners to reflect their consequently lower management fees. But in 2003, don't expect too many other firms to return uncommitted capital, the total of which is estimated to be $100 billion. Instead, look for firms to use this money in lieu of raising additional funds.

WINNERS

Venture firms with enough capital in their funds to make follow-on investments through at least 2003; including Morgenthaler Ventures, New Enterprise Associates, and Warburg Pincus; profitable startups seeking growth capital; and profitable or near-profitable late-stage firms that will have the pick of the litter in choosing investors.

LOSERS

Early-stage firms still investing out of 1998, 1999, or 2000 funds, like 21 VC Partners, Maveron, and North Bridge Venture Partners (they risk depleting funds, leaving insufficient reserves for follow-on), and unprofitable startups that raised their last round in 2000 and are coming back for more in 2003.

WHAT IT MEANS

The coming year will be tough for startups. Expect the bulk of that $100 billion to be sunk into late-stage companies, spin-offs, and public companies, which these days are often valued as low as any new startup. This is good news for cash-rich VCs. On the cheap they can fund an enterprise that has a much longer track record and is closer to reaching success than an equally valued risky startup.

"Until they stop giving away late-stage companies, there won't be a lot of logic to pursuing very early-stage deals," says one early-stage investor who asked to remain anonymous.

But late-stage companies won't have it easy either, says Tracy Lefteroff, global managing partner of the VC practice in PricewaterhouseCoopers's Global Technology Industry Group. He says a flood of firms that raised their last rounds in 2000—about 11,800 companies, according to the research firm Venture Economics—will be returning to VCs for new money in 2003. Only those with a very short timeline to profitability stand a chance of raising that next round. So expect a new wave of company closures in 2003.

ON THE HORIZON

For the most part, then, 2003 will be the year of the tortoise: companies and venture firms will trudge toward the finish line, that elusive liquidity event on the horizon. Slow and steady is fine, especially since there aren't any hares in the race. But by 2004, expect VCs and their LPs to get restless and pick up their feet. Industry observers estimate that 80 percent of the established, well-respected VC firms will be hitting up LPs for capital for new funds in 2004 or 2005.

Kelly Williams, a director at the investment bank Credit Suisse First Boston, says she and other managers of funds like hers have been disappointed with the quality of firms raising money in 2001 and 2002, and they look forward to top firms returning to the fund-raising market. VC firms that are seeking their third or later fund are in good shape because they have a pre-bubble track record by which LPs can assess their odds for positive returns (see "Marking Time," page 70). These new funds will then act as a clean slate for fund-raising, allowing firms more flexibility to invest in early-stage companies. ■

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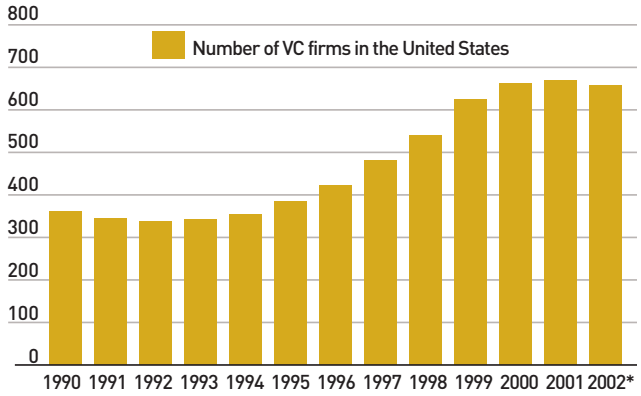
VENTURES GAINED

Almost 250 new VC firms came into existence between 1996 and 2001.



*Estimate. SOURCE: PricewaterhouseCoopers/Venture Economics/National Venture Capital Association Money Tree Survey