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Feature Story

Will Silicon Valley Rise Again?

by Bonnie Azab Powell

Venture capital is bubbling, people are hiring, and a rebound looks official. The area's most enthusiastic boosters discount the challenge from China and India. But nobody's popping the champagne just yet.

Six years ago this past March 11, the roller coaster that was the NASDAQ stock market clicked up to a record 5132.52. Then it promptly screamed back to earth, with the composite index finally hitting bottom in October 2002 at 1114.11. Thousands of companies folded, investors lost trillions, and some 200,000 Silicon Valley workers found themselves without a job. Whole office parks sprouted “For Lease” signs practically overnight. San Francisco’s once-bustling South Park neighborhood reverted to its roots as a destination for the kind of shopping cart trundled by the homeless rather than the kind filled by online buyers. It felt as though some sort of plague had struck, with the survivors walking around grim-faced and dazed.

But not only did the strong survive, they appear to be flourishing. Last year saw the creation of 2,000 new jobs in the region, according to the *Index of Silicon Valley*, an annual economic report published by Joint Venture: Silicon Valley Network. That’s a small enough number, but still the first net increase since the crash. Perhaps more significant, venture capital funds were flush too. Thomson Venture Economics and the National Venture Capital Association (NVCA) report that 182 U.S.-based venture funds raised \$25.2 billion in 2005 from their again-optimistic limited partners—46% more than they raised in 2004 and the highest annual total for venture funds since 2001. And those venture capitalists are doling out the money they’ve been sitting on since the crash. They invested \$7.6 billion in Silicon Valley companies in 2005, according to the annual MoneyTree Survey by PricewaterhouseCoopers, Thomson, and the NVCA. The total was slightly down from 2004’s \$7.8 billion—or was it? Many believe that venture firms actually invested more in 2005 than they did in 2004 but underreported their early-stage investment because of a newfound caution about tipping their hands.

In Silicon Valley, even getting out of the basement is progress. “We’ve returned to pre-boom levels,” says Russell Hancock, president and CEO of Joint Venture, a consortium of business, government, academic, and other leaders in Silicon Valley. “In terms of any of the indicators, like venture funding, R&D patents, market performance, and job generation, it feels like we’re at last back to normal, doing what we do best—starting new companies and innovating new products.”

The rebound doesn’t have the digerati singing in the streets, however, and for good reason. No one wants to be too cocksure that it will last. Even superbooster Hancock warns, “We shouldn’t be going around popping any champagne corks.” Others are downright pessimistic. “American dominance in the world of technology has ended,” warns Michael Moritz, the Sequoia Capital partner lauded as Silicon Valley’s top dealmaker for his prescient investments in Yahoo, PayPal, and Google. “Most people in the U.S. have yet to come to grips with this, but the mantle has passed to other countries—India, China, and Eastern Europe, all places where complacency and entitlement have not taken root.”

Sequoia and other top-tier Valley venture firms are hedging their bets by launching China-focused funds. Sequoia Capital China attracted \$200 million late last year for investments, while a joint venture of International Data Group and Accel Partners raised \$150 million from limited partners eager to invest in China. Draper Fisher Jurvetson, which already has offices and investor partners in Beijing and Shanghai, is raising a \$200 million fund earmarked for start-ups in India.

Not everyone fears that Silicon Valley is about to take a back seat to Bangalore and Shanghai. On the contrary, says AnnaLee Saxenian, author of three books about the region, including 1994’s *Regional Advantage: Culture and Competition in Silicon Valley and Route 128*, a seminal study of the strengths that put Silicon Valley out in front of other places. “Silicon Valley has a 50-year head start, but it has more than this—it has a depth of talent and experience and know-how that doesn’t exist anywhere else in the world because of that head start,” says Saxenian, the dean of UC Berkeley’s School of Information Management and Systems and a professor in the department of city and regional planning. “I’ve spent a lot of time in India and China and

elsewhere, and while they're very good at what they do, Silicon Valley's start-up infrastructure—the attitude toward risk-taking, the circulation of ideas, the speed with which you can start a company and get it moving fast—remains unsurpassed.”

The best indicator that Silicon Valley is once again open for business is the amount of venture capital being put to work funding companies. The \$7.6 billion invested there in 2005 represented more than a third of the \$21.7 billion that venture funders dispensed to all U.S. companies, according to the MoneyTree Survey. That's a mere fraction of the \$104.7 billion that went into start-ups in 2000, but back then many a Fortune 500 company had launched a venture arm and even dentists were dabbling in seed investing. Last year's total is the second annual increase in a row.

Silicon Valley's 35.2% share compared with 12.1% for the next-closest region, New England. (MoneyTree's Silicon Valley includes San Francisco and other Bay Area cities, while the *Index of Silicon Valley's* does not.) By contrast, the Indian Venture Capital Association estimates that funding of Indian companies totaled \$1.3 billion. Venture firms invested \$1.1 billion in Chinese companies in 2005, according to Zero2ipo, a research and advisory company based in Beijing.

Rivalry abroad isn't necessarily a bad thing. “Competition only brings out the best, and it's only good news for us if China prospers as a greater market for Valley innovation,” contends Joint Venture's Russell Hancock. While some programming and development jobs have moved to India, the fact that in 2005 the average Valley salary increased 2.7% from 2004 levels, to \$69,455, tells him that the region has retained creative, higher-paid jobs in fields like industrial design. “Yes, our companies are offshoring and outsourcing,” he says, “but we're also seeing them set up global distribution and supply chains.” Saxenian agrees, saying that the Valley's economy has changed radically over the last decade. “It's much more deeply connected globally, to India, China, and Taiwan and to other parts of the world,” she notes.

Increasingly common are “Valley” companies like UPEK Inc., a start-up that makes such biometric-authentication equipment as a fingerprint scanner used as a security device for ThinkPads and other notebook computers. The design and programming operations are split between the Bay Area and the Czech

Republic—it was originally spun off from a Swiss company. Production and sales are in Asia, the better to serve Lenovo, the Chinese manufacturer that bought IBM’s laptop business.

Spending more time abroad isn’t the only change in how venture capitalists do their stuff. They’re also investing more in later-stage companies than they have in past years, and for good reason. Early-stage enterprises simply aren’t likely to pay the dividends that they once did. “Early-stage is still a terrible place for entrepreneurs to raise money,” says Ian Sobieski, founder and managing director of the Band of Angels Fund, a \$50 million venture fund that seems to like terrible places. It invests small amounts—usually around \$300,000—in fledgling start-ups. “Most VCs have abandoned seed-stage investing,” says Sobieski. “We have very little competition.”

The young companies that get funded generally have left the crib and started to toddle. Take Ugobe Inc., a robotic-toy company based in the Bay Area that makes an extremely lifelike animatronic dinosaur. Its co-founders are two 40-something software whizzes: Caleb Chung, the brains behind the bestselling interactive Furby toy, and Ted Cohn, a veteran of Apple Computer. By the time Ugobe sought outside funding, it had already developed a full-scale prototype, lined up agreements with a Chinese manufacturer, and generated strong interest from U.S. and Chinese retailers—bagging as much as \$18 million in preorders.

Ugobe exemplifies the resourcefulness necessary to attract seed investors these days. “Before they can even raise any money from us, entrepreneurs have to figure out a way to get to milestones that they used not to have to dream of,” Sobieski says. “The capital markets are less friendly to investing with people with just an idea,” which was commonplace in the days before the technology crash. The Band of Angels joined Chinese venture capitalists to put \$2.5 million into Ugobe in mid-2005.

The biggest increase in early-stage investing—ready for some whiplash?—went to Internet-specific start-ups: 161 received \$840 million last year, according to the MoneyTree Survey, up 89% from 2004, when \$443 million went to 96 companies. Around the Valley, the already tiresome moniker “Web 2.0” is used to refer to these second-generation Internet companies, many of which seek to help Web users filter the mass of online content being produced

today. Web 2.0 companies include Facebook, an ad-funded community website for college students, which raised \$12.7 million in April 2005. Another, PodShow, a site that helps users share homemade radio programs, raised just under \$9 million in August. Meebo, which operates a site that aggregates the most popular instant-messaging programs, was the object of a bidding war among venture capitalists. Sequoia Capital eventually won the right to invest in it, valuing Meebo at a rumored preinvestment price of \$10 million.

The other sector collecting heavy Valley buzz is biotechnology. So far the expected surge in investment resulting from the passage of California's Proposition 71, which allocates \$3 billion to state funding of stem-cell research, hasn't materialized. Nevertheless, the MoneyTree Survey's life-sciences sector, comprising the biotechnology and medical-devices industries, reached a five-year high in 2005, with \$6 billion doled out to start-ups—an amount that accounted for 28% of all venture capital investment.

Could biotech be the engine of another boom? "I don't think the sector is overhyped," says Russell Hancock, although he notes that product development is notoriously capital-intensive and fraught with landmines along the difficult path to approval by the Food and Drug Administration. He believes that Silicon Valley's future dominance of the sector could be derailed only if the federal government fails to get on board. "It's ours to lose. Right now we have more assets than anyone else—the labs, the top research universities, the funding, and the way we connect those institutions with more informal entrepreneurial activity," he argues. "The federal government has to be a player here. In previous waves of innovation, that wasn't the case. When Jerry Yang was in his Stanford dorm room starting Yahoo, he didn't have to court the government to get clinical trials approved or lobby for research dollars."

The federal government aside, the biggest roadblock to the Valley's recovery is the unfriendly market for initial public offerings of technology companies. Last year there were only 56 venture-backed IPOs, compared with 93 in 2004—still far below 2000's peak of 264. The hottest debut was that of Baidu.com, a Chinese search company whose shares shot up more than 350% on its first day of trading on the NASDAQ. Baidu.com was touted as the Google of China, and its giant first-day pop was attributed to investors who'd

felt left out of the Google IPO juggernaut. (Although Google's shares slid earlier this year, they were still trading at around \$365 in early March, comfortably up from their August 2004 offering price of \$85.)

But Baidu is no Google. Where the Mountain View, California, search company had billions in revenues and several profitable quarters behind it before it went public, Baidu took in revenues of only \$13.4 million in 2004, with \$30 million expected for 2005. Stock analysts, still flinching from accusations that they turned a blind eye to the ephemerality of the first wave of dot-coms, swiftly set the record straight. Several top analysts—including Piper Jaffray's Safa Rashtchy, who has famously predicted that Google shares could hit \$600 in 2006—rated Baidu “underperform,” a tacit command to sell. The company's shares promptly cratered and were trading at about \$50 in early March, compared with their opening-day close of nearly \$123.

Baidu was something of an exception among recent IPOs, however. Most were more akin to iRobot Corp. The 16-year-old Massachusetts company—which designs robots for military and commercial uses, including the Roomba floor vacuum sold in Sharper Image catalogs—had a \$103.2 million IPO on November 8, with a first-day gain of 42%. In early March, shares of iRobot were trading at approximately \$27, about where they started.

Observers are divided on whether to attribute the lackluster IPO market to the high bar set by investors or to the possibility that candidates are turned off by Sarbanes-Oxley restrictions. Technorati in general are sour on the reform law, in no small part because of what they see as overly onerous reporting requirements. Mark Heesen, president of the NVCA, recently said in a statement, “For the IPO market to improve, we need relief from certain hurdles associated with the Sarbanes-Oxley Act.” He declined to comment further, but venture capitalist Bob Pavey, a Cleveland-based general partner at Morgenthaler Ventures and a former chairman of the NVCA, spells out what not getting relief might mean. “Unless the SEC figures out how anti-growth and anti-jobs the impact of Sarbanes-Oxley is on young growth companies considering an IPO, we will see U.S. venture-backed companies doing what until now has been unthinkable: going public on foreign stock exchanges like the Toronto Exchange or [the London Stock Exchange's] AIM.”

Ian Sobieski of the Band of Angels, who is also a fellow of UC Berkeley's

Center for Entrepreneurship & Technology, puts the same concern differently. If Sarbanes-Oxley is not amended to lessen the onus of compliance for young companies—one estimate places the average annual cost for corporations with revenues of less than \$1 billion at \$3.4 million—“you could see a real chill on the way the financial food chain supplies capital to start-ups,” he warns. “Fewer exits [the chance to cash out] means smaller returns. LPs [limited partners] will decrease their allocation to venture funds, the amount of money to entrepreneurs will decrease, and that means less innovation.”

Meanwhile, Michael Moritz of Sequoia is happy to reprise his pessimist role. “It is more difficult and less appealing to become a public company,” he says. “The impatience of public investors, coupled with the McCarthyite hunt for demons in every corporate nook, makes it far more appealing to sell companies than to withstand the scorn, scrutiny, and suspicion of trigger-happy shareholders who rent rather than own.”

Indeed, far more high-profile venture-backed technology companies have been acquired than taken public in the past few years. Rupert Murdoch’s News Corp. paid an eyebrow-raising \$580 million for MySpace.com, a wildly popular social-networking site, last year. (For more on MySpace, see “Now Consider the Home Front” on the next page.) Also in 2005, Web auctioneer eBay bought Skype.com, a Luxembourg-based voice-over-IP Internet phone company, for \$2.6 billion, making members of Silicon Valley’s Draper Fisher Jurvetson venture capital firm, which had paid around \$19 million for a 10% stake in Skype, a bunch of very happy investors. (DFJ hit two home runs last year, having also owned 28% of pre-IPO Baidu through an affiliate.) Scores of smaller acquisitions abound. Yahoo, for example, bought the online photo-sharing site Flickr for a rumored \$35 million, and rival Google snapped up Urchin, a Web-analytics software company, for an amount thought to be similar.

In January Microsoft acquired Seadragon Software, a Seattle search-software developer that the Band of Angels had invested in. While the terms of the deal were not disclosed, Sobieski hints that the group’s payout more than tripled its investment. He’s happy about that, but it’s a far cry from the 100-times multiples enjoyed by investors whose companies went public in the boom days.

“The exit market is just not very robust,” says Sobieski. Overall mergers-and-acquisitions activity for 2005 was slightly down from the previous year. “The lack of liquidity has really affected people—there’s a quiet feeling of unease,” he says. “People aren’t trying to flip companies and playing some game; they’re building companies of real value. So I think there’s still optimism that as long as the fundamentals are there, eventually the capital markets will make it possible to exit again.”

With the gold diggers that were attracted to the Internet rush long departed, the Valley’s veterans know how to be patient. After all, Silicon Valley has weathered three boom-and-bust cycles in the past 50 years—the microchip revolution, which sparked the personal-computer explosion, which in turn fueled the rise of the Internet companies. The hangover from the dot-com boom is still fresh in the common memory, and nobody professes any desire for a repeat. Sobieski, for one, practically shudders when asked what he thinks will be the driver of the next boom. “I don’t want there to be a boom of any sort,” he says. “I just want there to be steady innovation.”

“Steady” isn’t a word often applied to the topsy-turvy, high-stakes world of venture-backed start-ups. But given the Valley’s long history of birthing technologies that change the way we live and work, it may be the velocity of choice.

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