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Venture-Capital Firms Caught in a Shakeout

By PUI-WING TAM

The technology bubble popped a decade ago, but the venture-capital industry that helped finance the boom stayed largely intact. Now venture-capital firms are going through their own brutal culling.

Venture firms are struggling to raise new cash, hampered by poor investment returns and a difficult economy. Last year, 125 venture funds in the U.S. collected $13.6 billion, down from 203 funds that raised $28.7 billion in 2008 and down from 217 funds that raised $40.8 billion in 2007, according to data tracker VentureSource.

"There are a lot of firms that have dropped off," says Rebecca Lynn, a principal at venture capital firm Morgenthaler Ventures in Menlo Park, Calif. "We'll see a continued shakeout as a lot of firms that aren't the top firms won't be around."

There were 794 active venture-capital firms in the U.S. at the end of 2009, meaning they have raised money in the last eight years, down from a peak of 1,023 in 2005, according to Thomson Reuters and the National Venture Capital Association.

Amid all the gloom, some start-ups are still managing to find backers. Pacific Biosciences Inc., which makes DNA sequencing instruments, has raised more than $260 million and tops a list of 50 venture-funded companies compiled by research firm VentureSource, a unit of Wall Street Journal owner News Corp. (See the complete list.)

Many venture firms—which put money into young companies with the aim of profiting later when those firms are sold or go public—profited handsomely in the boom years in the late 1990s and early 2000, when the industry fueled the dot-com bubble and spawned hits such as eBay Inc. and Yahoo Inc. Even when the boom went bust, venture firms kept going because their funds typically are set up as long-term, 10-year investment vehicles that don't quickly close down like a hedge fund might.

But in the past decade, many start-ups have flopped or have struggled to go public amid an unwelcoming market for inital public offerings. The tough environment has been exacerbated by the credit crunch, which makes it difficult for many start-ups to obtain bank lines of credit, say venture capitalists.

While failed start-ups aren't new, some of the busts have been particularly big recently, with the investments selling their assets for just a tiny fraction of the amount they raised.

Take, for example, Copan Systems Inc. The data-storage company, based in Longmont, Colo., raised more than $107 million in venture capital over the past eight years, according to VentureSource. Despite all the cash, the start-up fizzled: Late last month, Copan's assets were sold in a private foreclosure sale to Silicon Graphics International Corp. for $2 million.

"The company had some traction but it just required too much money to get there," says Phil Siegel, a partner at venture-capital firm Austin Ventures, which invested in Copan. Silicon Graphics acknowledges that it got a good deal.

The market has been lukewarm toward venture-backed initial public offerings since the dot-com bust in 2000 and 2001. And while some venture capitalists have profited in recent years by selling start-ups for big sums—think of Google Inc.'s $1.7 billion purchase of video site YouTube in 2006—the returns from such deals typically aren't as lucrative as those generated by IPOs.

Overall, venture-backed companies generated $17.1 billion in IPOs and mergers and acquisitions in 2009, down 34% from $26.1 billion produced in 2008, according to VentureSource.

Many venture capitalists—especially those working at lesser-known firms that don't have the same access to the best deals as high-profile firms such as Sequoia Capital and Accel Partners—don't have much of a track record to show investors as they try and garner new cash. As a result, some venture firms are winding down.

Frazier Technology Ventures late last year said it didn't plan to raise a new fund. Len Jordan, a partner at the Seattle venture fund, says the firm "concluded it wouldn't be successful in raising a new fund after we had spent some time trying."

Frazier Technology is continuing to support the start-ups it has invested in out of its current $104 million fund, says Mr. Jordan.

Other venture firms are lowering their fund fees or are raising smaller funds than in the past. Late last year, venture-capital firm Highland Capital closed a $400 million fund, half the size of its previous fund, which was raised in 2006.

And Draper Fisher Jurvetson, Battery Ventures and Opus Capital have all offered lower fees to investors in recent months as they have pursued new funds.

In response to the tough environment, some venture firms are searching for better returns in new areas. While Steamboat Ventures, an affiliate of Walt Disney Co., has continued to have exits in the U.S., it has also focused overseas in the past four years, particularly in markets like China, says John Ball, a Steamboat managing director.

The venture firm today has a third of its capital allocated to Asia, with two thirds in the U.S., he says. "It's a useful way to diversify across markets," says Mr. Ball.

Meanwhile, Austin Ventures has de-emphasized its investments in young companies and is instead focused on larger private-equity deals that take $15 million to $25 million of capital, says Mr. Siegel.

That arena is less crowded, he says, which means there's more opportunity. "We're moving to where the puck is going," says Mr. Siegel.

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