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Venture Capital - The Changing Lancscape

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Venture Capital – the Changing Landscape

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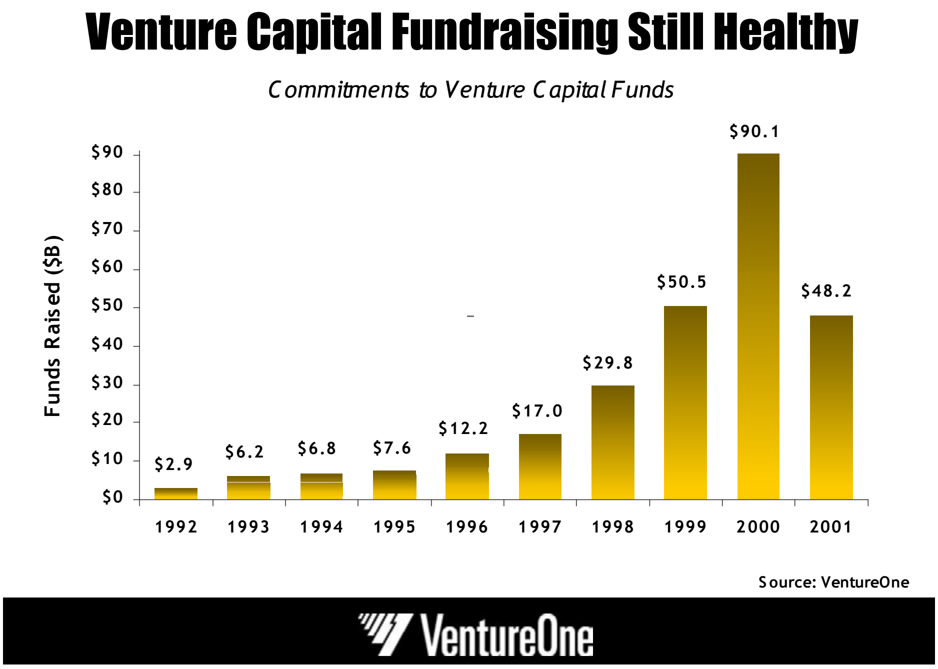
" I have not seen the funding situation this bad in the 35 years that I have been in the Venture Capital business" said Dick Kramlich of NEA in Q3 2001. We have witnessed the entire bubble of free money flow and start up boom of the 1999 and 2000 burst last year and things have been extremely tough ever since. I feel that one needs to think like a contrarian and take heart in the fact that we are getting healthy. We are getting healthy from the sickness that had plagued Silicon Valley where valuations had no ceilings, real estate had skyrocketed to four to five times its prior rates. Every relatively young engineer who came looking for a job wanted at least $100K in salary and 1% equity in the company and executives in start ups were being shuttled from Black Hawk to Silicon Valley offices in private limousines and the list goes on. How did we allow all these things to happen? Aren't VCs supposed to be smarter than that? God only knows!!

Entrepreneurs who have had very tough times raising money in the last year for their companies to survive may question my audacity to say what I have just said. I state with full conviction that what is happening is for the long term good of both the VCs and the entrepreneurs. After the unsustainable hype of the onslaught of the internet technology in every aspect of our lives and businesses, things have come back to being more normal and sustainable in the long term. It is time to separate the real entrepreneurs from the many "me too" start ups that sprang up everywhere with the money bubble that the VCs raised and invested for about three years as shown by the bar charts below.



At this juncture, let me draw the distinction between the traditional VCs of Silicon Valley and what I loosely call the Dot Com VCs. The VC business as it evolved in Silicon Valley from the sixties, was founded by very successful entrepreneurs or highly successful executives of companies like Fairchild, HP, Varian and many of the early pioneering companies in the valley. They put their own and others' money together to form $ 15 to $20M funds and started investing in start ups and getting personally involved in helping to nurture them and mentor the founders and make them successful over a few years horizon. This type of success led to more companies being started and funded with the same hands on model of VC involvement. People like Dick Kramlich of NEA, Don Valentine of Sequoia, Dave Kleiner of Kleiner Perkins are some of the examples of these pioneering and successful VCs. The real wealth creation in this process led to more and more successful startups in the valley and it became the envy of the entire world. The Dot Com VCs on the other hand came mostly from financial institutions, had combination of technical degrees and MBAs or just MBAs and virtually no experience in ever starting or running a company. They started funding companies by applying all kinds of spread sheet analyses to valuations, financial projections, exit strategies and quick IPOs that became the whole focus rather than building a real business or company. Growth became more important than profitability or real customer value. Quick IPOs became more important for the founders, the investors, the underwriters and the analysts who all had large stakes. This in itself became a shell game that had to collapse one day and it did.

The collapse in the equity markets have now brought the situation to more realistic considerations and VCs have gone back to looking at real value propositions, realistic valuations and real returns on their investments. This is therefore, real and healthy and hence my conviction as expressed above. Yes, several companies will die in this changed environment and several people will be disappointed with what is yet to come but let me use the analogy of forest fires and the destruction of undesired forest brush as part of the natural evolution of healthy forests.

So where do we all go from here? For the entrepreneurs the fundamental question should be whether they are trying to create aspirin or vitamins – the former is essential to kill a pain in the market and the latter is optional. This will be the key to a funding decision by the VCs and other investors. Only painkillers are likely to be funded. The other major consideration for an entrepreneur is that being fourth or fifth enterprise in a particular domain will significantly lower the chances of success and hence he or she should think hard to explore other ideas for their entrepreneurial zeal and ambitions. All other factors such as the team quality, market size and ability to execute and market the products are requirements that are a given and do not need to be elaborated upon here.

What are the industry domains that look attractive at this time? From a high technology perspective, opportunities in storage related technologies (both SAN and NAS), security of networks, security of storage, wireless local area network products, low power chips for various wireless devices, data communications products for the metropolitan markets and solving some of the pains of transporting high volumes of data to multiple locations over the wide area networks in a relatively short amount of time are areas that can still use innovations for the future. All these have both software and hardware opportunities and one can pick them based on one's areas of expertise and efficiencies of the solutions being proposed.

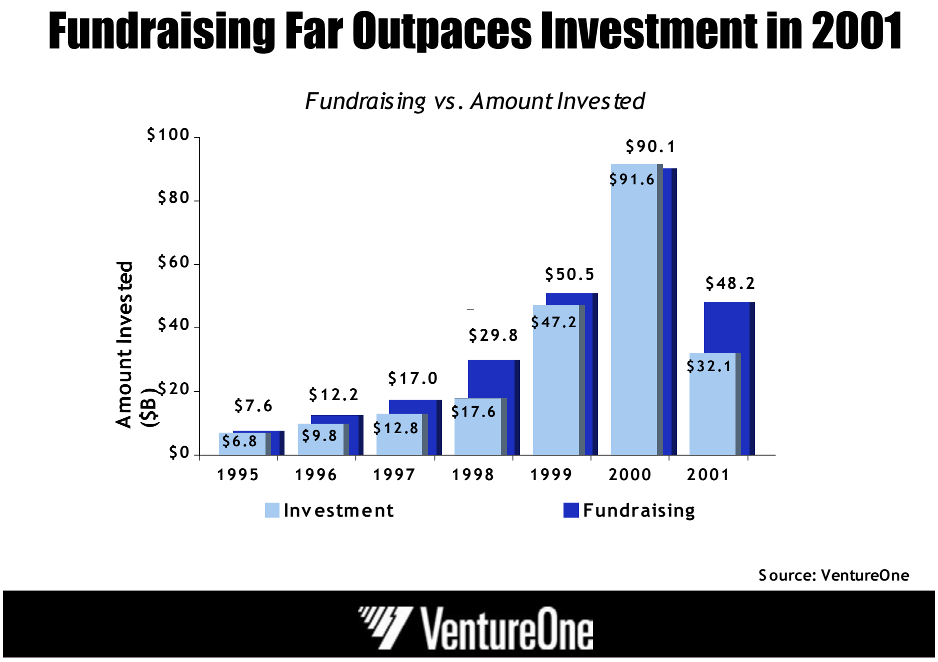
There is a renewed interest among some of the VCs in investing in biotechnology, bioinfomatics, life sciences, some segments of the Pharmaceutical industry and nano technology.

Let us take a brief look at the situation in India. The VC investments in India in the amounts that have occurred in the last three years is a relatively new phenomenon. However, the timing and the quality of investments that many of the VCs made in India was very dot com centric which may have given them a wrong start. Many VCs will take a while to recover from these non performing investments. Another issue that the Indian VC industry needs to look at seriously is the lack of technical talent and technical accomplishment among majority of their partners. Most of these partners are coming from finance background with very little ability to promote and nurture high technology product ideas and enterprises. The predominant current focus of India VCs is software services and business process out source ventures. While these are certainly viable and have their value with respect to cost arbitrage and getting returns on investments, the true value of venture capital in creating world class product companies is not being exploited to it's full potential in India. Until successful high tech industry executives in India decide to enter the VC business in the latter part of their careers, the country may not create very many venture backed high tech product companies. If someone can persuade the likes of Mr. Narayanamurthy of Infosys to mentor other entrepreneurs besides his own people as the Chief Mentor of Infosys, that could be the greatest achievement for entrepreneurial activity in India.

In terms of the big picture for VC funds invested in India, the situation is very healthy. The amount of VC investments in India in 2001 amounted to $842M and was the second highest after Japan and 24% of the total Asia Pacific VC investments during the year. Of this total, $460M or more than 50% was received by the Indian Telecom Services provider Bharati Tele-Ventures. This is one area where India did better than China and needs to focus on improving it every year. Current estimate of VC fund commitments for India is over US $ 2 billion. This amount can go a long way in creating several world class high technology companies. There are more than 60 VC funds operating in India at this time and as such the entrepreneurs have many options to choose from if they do their homework thoroughly.

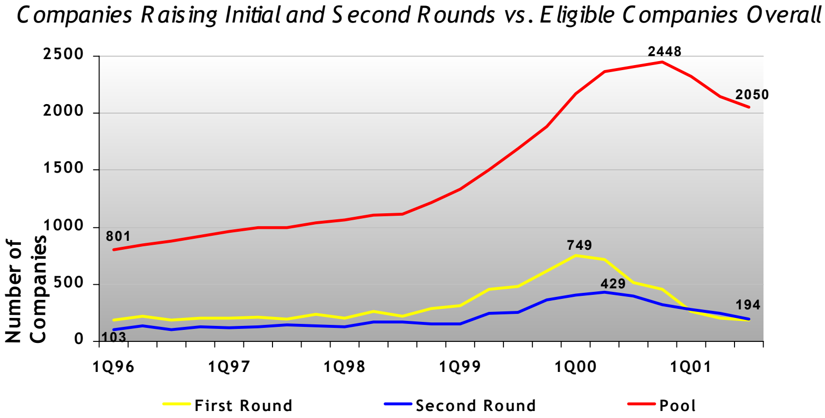
Focusing again on the big picture for VC investments, we can draw several conclusions from the data on Venture Capital published by the San Francisco based Venture One organization. Let me enumerate some of them.

While investments were down in 2001, the fund raising was at a higher pace and hence we can conclude that the VCs do have money to invest as indicated by the chart below. This trend may not continue in 2002 in view of the prolonged weakness in the equity markets world-wide.



There is a large inventory of companies that require second or third round funding and as such we will see the demise of many of these companies as many of them are not likely to get funded

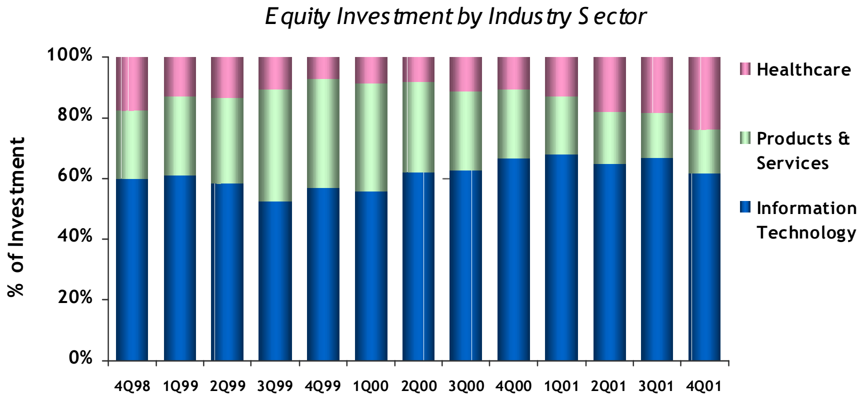
Dramatically Increasing 'Inventory' of Series B-Eligible Companies



Source: VentureOne

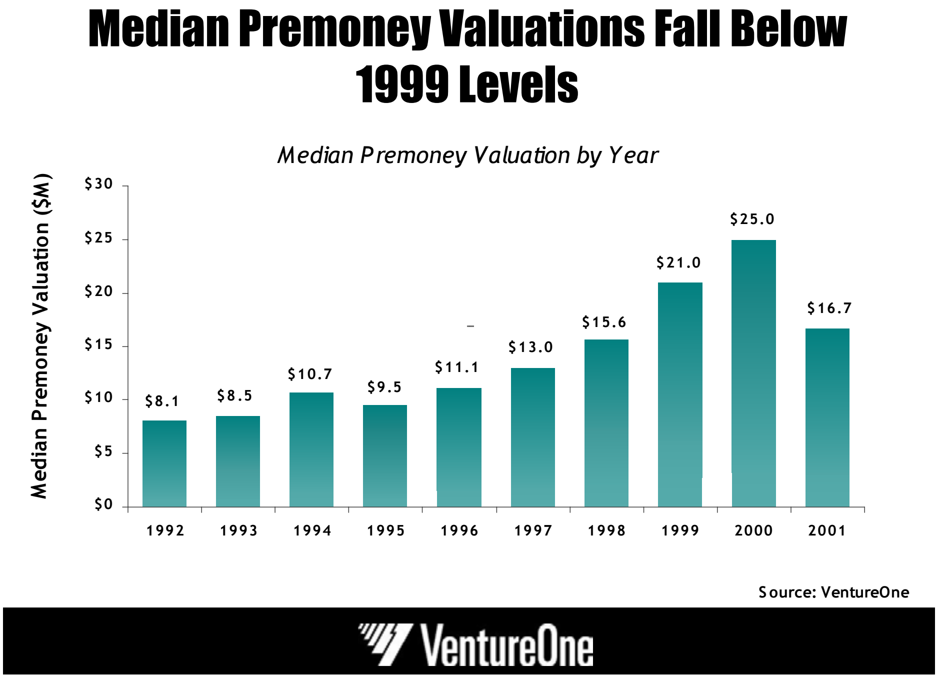
While IT investment is falling, the trend in healthcare investments is upwards as indicated by the following charts.

Healthcare Gradually Recaptures Investor Interest

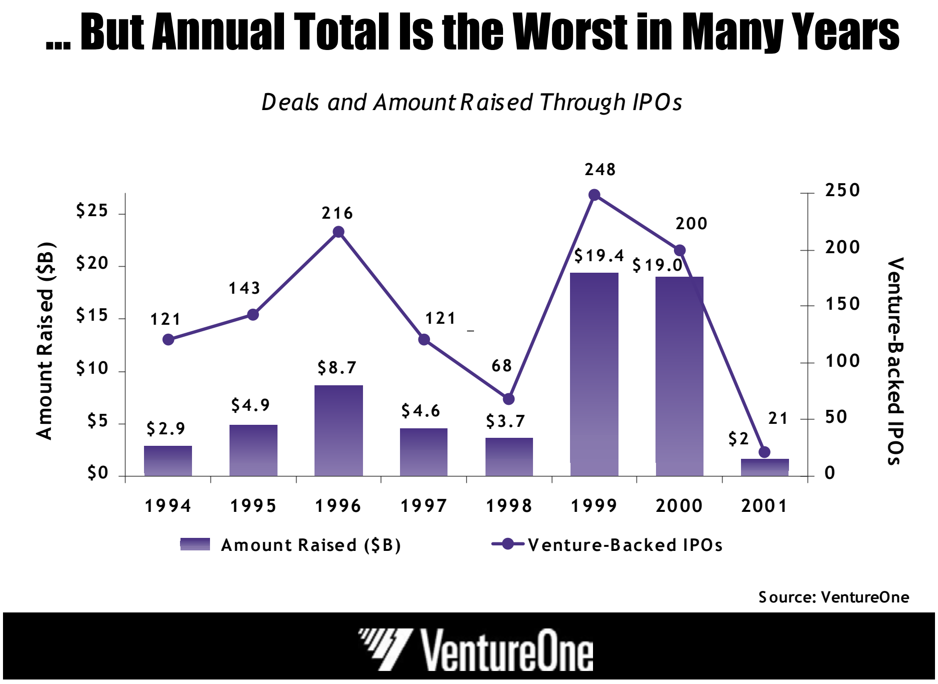


Source: VentureOne

Valuations were down significantly in 2001 but are still higher than the average of 1997 which is the last year before the bubble.



2001 was the worst year for the high tech IPOs in the last several years and as such a low number of liquidity events will further impede the flow of new investments unless things change drastically in the next few months.



In conclusion I want to present the views of a veteran and highly successful VC with a worldwide presence – Mr. Lip-Bu Tan, Chairman of the Walden International Investment Group with presence in the USA, Asia Pacific, India and Europe.

According to him, the current situation is stabilizing and US VC investments nationwide will be around $7B per quarter – the pace that prevailed before the investment bubble. VCs will still be focused on financing their own portfolio companies. There is, however, a pick up in new investments along with interest in biotech and life sciences. For the near future annualized VC returns will be down around 18 to 25%. For the five year horizon, 30 to 35% of the VC firms will disappear. Valuations will be down further and so will be the costs of doing business. So, this is good or bad depending on which side you are on but by no means this is a gloom and doom scenario and all of us need to rejoice and continue on our entrepreneurial passion !!