Silicon Valley's Backers Grapple With Era of Diminished Returns
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After decades of powering -- and profiting from -- the technology sector's growth, Silicon Valley's venture capitalists are grappling with an era of diminished returns.

The industry that grew rich supplying early funding to tech giants like Microsoft Corp. and Apple Computer Inc. is being weighed down by a skittish stock market, a glut of investment capital and slowing growth in the tech areas that have been most lucrative for backers.

Venture capitalists typically invest in young companies, such as tech start-ups. Many of their investments turn out to be losers, but they hope for big paydays when a company they back is sold or goes public.

For the past several years, the flood of cash pouring into the formerly small and clubby venture-capital industry has helped make those paydays leaner by increasing competition for deals. The industry now manages close to $260 billion, much of it from pension funds, university endowments and other investors seeking higher returns than from stocks or bonds.
Venture capital "will never be the business it was in the mid-1990s," and won't reach the frenzied levels of the dot-com boom, says Paul J. Ferri, who founded Matrix Partners in 1982. "I know what we have distributed to our investors over the last six years, and it's damn little."

Mr. Ferri says he and his partners at Matrix, an early backer of Apple Computer, considered closing their Waltham, Mass., firm a few years ago because the industry's future looked so bleak. "I thought by now investors would have figured out that our industry is not an economically viable business model," he says.

Venture-capital returns are hard to gauge, partly because of the difficulty of putting a value on small, private companies. Cumulative returns for the past six years remain negative, still smarting from the dot-com meltdown. Though they have recovered since then, they are still well below the yearly levels of the mid- to late 1990s, when they sometimes exceeded 50%.

Last year U.S. venture capitalists posted a mean return, including realized and unrealized gains, of 7.9%, according to research firm Cambridge Associates. For the year ended March 31, returns were 13.8%, barely beating the 11.7% gain of the Standard & Poor's 500-stock index.

Investors generally expect outsize returns from venture capital, to compensate for the high risk of investing in start-ups and the lack of liquidity. They can't pull cash out of venture funds as easily as out of stocks or mutual funds.

But all the new money chasing a limited number of promising start-ups is bidding up the price of venture deals, putting pressure on returns. Adding to the squeeze is the harsh climate for initial public offerings of stock. Last year, there were 56 venture-backed IPOs in the U.S., just a quarter as many as in 1995.

New regulatory constraints, like the Sarbanes-Oxley corporate-governance law, coupled with Wall Street's recent preference for larger IPOs, are prolonging the time that private companies stay private -- delaying venture capitalists' payoffs.

Rather than taking their best prospects public, many venture investors are selling them to larger companies. But the profit margins can be relatively slim. In the second quarter, only 4 out of 31 of such deals earned venture investors a return of more than 10 times their investment. In nearly a third of those deals, investors lost money, according to Thomson Financial and the National Venture Capital Association.

The venture industry's slump comes as Silicon Valley's broader economy is rebounding. But growth is slowing in some parts of the tech sector, such as personal computers, that have provided big profits to venture capitalists. Some in the venture industry say tougher times are simply part of the Silicon Valley boom-bust cycle, but others think they could be here to stay. Already, reduced profits are
prompting some venture firms to consider less risky investments, such as buyouts of public companies. Others are seeking fatter returns in faster-growing markets like China and India.

Elite venture firms with ties to proven entrepreneurs say they continue to find innovative companies and rack up profits. While there has long been too much capital in venture, "we've been able to make really, really substantial absolute returns for [investors] we've worked with for a long time," says John Doerr, a partner at Kleiner Perkins Caufield & Byers. The Menlo Park, Calif., firm, which backed Amazon.com Inc. and Google Inc., declined to provide exact return figures. But traditionally, a small group of top firms, like Kleiner, has accounted for the bulk of the industry's returns.

The venture industry raises less money than at the height of the dot-com boom, and remains dwarfed by the buyout and hedge-fund industries. Still, even Kleiner acknowledges that today's crush of capital and other factors have made it tougher for the more than 860 venture firms in the U.S.

Kleiner says more than 725 venture-backed start-ups were formed in 2005, at least twice as many as in the early-to-mid-1990s. But since 2001, the number of "exits" through IPOs or company sales has stayed at 350 to 450 a year. "We're in a position where almost one in two venture-backed companies will fail...It's hard to see how the industry gets around that basic math," says John Denniston, a Kleiner partner.

Some venture firms are adapting. Matrix, along with Sequoia Capital, of Menlo Park, recently announced expansion into India. In the U.S., as more companies in the same sectors get money from cash-rich venture capitalists, they "bash their brains out against each other, consuming vast amounts of capital," which lowers returns, says Sequoia partner Michael Moritz.

The relatively easy availability of venture capital has been a boon to Silicon Valley entrepreneurs. In the past two years, Seattle online employment recruiter Jobster Inc. has raised millions of dollars "on our terms" from investors, says Jobster Chief Executive Jason Goldberg.

While he wasn't looking for any money, Mr. Goldberg ended up getting $37.5 million in the company's past two funding rounds. The downside: His investors, having put nearly $50 million into Jobster, expect its value to reach 10 times that, or $500 million -- a tough goal.

Last year, big institutional investors put $25.2 billion in venture capital, the most since 2001, according to Thomson Financial and the National Venture Capital Association. Many are dazzled by past coups like the IPO of Google, which made billions for Kleiner and Sequoia.

But in an effort to maximize returns, top-tier venture firms like Kleiner, Sequoia,
Matrix and Benchmark Capital are admitting few, if any, new investors. That leaves new investors with little choice but to flock to less-proven funds.

"It's really a small set of [investors] who are getting all the goodies," says Josh Lerner, a professor at Harvard Business School who has studied venture capital. But since most funds invest and reap returns over a 10-year period, it can take a while for investors to recognize duds, he says.

Some investors who have made fortunes in venture capital are pulling back. The endowments of Stanford and Yale universities are devoting smaller percentages of their money to private equity, a category into which they lump venture capital, the schools' annual reports show. Stanford last year was targeting 10% of its $12.4 billion "merged endowment pool" for private equity, down from 17% in 2001. Officials from Stanford and Yale, which has a $15.2 billion endowment, declined to comment.

Princeton University is also scaling back its endowment's venture commitments as a percentage of assets, mainly because its $12 billion endowment can't get enough money "into the funds that we would like," says Dan Feder, a managing director with the Princeton University Investment Co. While the school remains "enthusiastic" about investing with a handful of top firms, "I don't think [venture capital generally] is all that compelling," he says.

By contrast, the state of New Jersey's division of investment, which oversees a $73 billion state pension portfolio, wants to double the money it invests in venture capital to $100 million this fiscal year. "We feel private equity will outperform public equity going forward," says William G. Clark, the division's director. But, with top venture firms accepting so little new capital that "makes it very hard" for new investors like his fund, he says.

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