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Venture Capital

VCs: Tighten Your Purse Strings

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BURLINGAME, CALIF. -

Venture capitalists have been making a stink lately about the anemic IPO market, blaming it for their sub-par returns. But a new research paper says the problem isn't so much a lack of IPOs--it's a lack of discipline among VCs.

Paul Kedrosky, a senior fellow with the Ewing Marion Kauffman Foundation, which studies entrepreneurship, posits that venture-capital returns have suffered mostly because VCs are plowing too much money into too many companies, particularly traditional information-technology start-ups that aren't generating the huge profits they did in the 1990s. He suggests venture capitalists should be investing about half as much money per year as they do now--about $12 billion to $15 billion.

Last year, U.S. VCs sank about $28 billion into start-ups, according to the National Venture Capital Association.

The industry must "shrink its way back to health," Kedrosky writes in the new Kauffman paper, released Wednesday. He argues that a five-fold increase in the amount of money raised by venture capitalists from 1996 to 2001 led to "a collapse in performance from which the sector has never recovered." Too much cash chasing too many unproven start-ups has led to pricey valuations, he says, and lower profits when companies finally do go public or are scooped up by acquirers.

So is the industry getting the message?

Yes and no. New figures from the National Venture Capital Association show that the sector did contract last year: There are now about 882 venture firms in the U.S., down from 1,019 at the end of 2007. Total capital under management shrunk to $197 billion, from $258 billion the year before.

But a survey from the NVCA and Deloitte & Touche, also released Wednesday, shows that for many VC firms, it's more or less business as usual--despite an unprecedented financial crisis that has cast a pall over their industry.

Of the biggest VC firms surveyed--those with more than $1 billion under management--51% said they are investing less money in start-ups as a result of the recession. But 36% said they're holding investment levels steady. Thirteen percent are actually investing more.

What's more, 83% of the biggest firms, and 82% of smaller firms (those managing $500 million to $1 billion) said they are maintaining the same strategy as far as investing in specific industries.

More than half the venture firms surveyed planned to keep allocations for telecommunications investments the same over the next three years, and 60% said they wouldn't change their software strategy. Still, 50% said they expected to put less money in the semiconductor industry. Sixty-three percent forecasted plowing more cash into "clean" technologies, like companies promoting energy efficiency.

Mark Heesen, the venture-capital association's president, said on a conference call with reporters Tuesday that the industry as a whole "is going to contract." But he believes total investments this year could match the levels seen in 2008.

"I don't think that there's too much money [being invested] for early stage" companies, added Terry McGuire, a managing general partner with Polaris Venture Partners in Waltham, Mass.

Many venture capitalists point out that clean-technology investments--particularly big-ticket projects like solar and biofuels plants--require more capital than yesterday's software or Internet start-ups. So VCs are justified in continuing to raise large amounts of cash. But Kauffman's Kedrosky, a former venture capitalist himself, says that should only matter if VCs were still generating profits for their investors--which, as an industry, they're not.

"I don't really care how much money clean-tech needs. I need to start seeing positive [profit] numbers," Kedrosky told Forbes. Venture capital is down 17% over the last year, he says. That's far better than the S&P 500, which is off 38%. But venture investors expect far better returns because of the risky nature of the business and the fact that their money is usually tied up with VC firms for many years.

Over the last 10 years, venture capital as an industry has returned about 8% to its investors, again outpacing the S&P 500 and Russell 2000. But next year, the 10-year venture figure is expected to go negative, since it will no longer include profits from the dot-com boom.

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