Venture Capital's Dilemma

Scarred by memories of their dot-com losses, cash-rich VCs remain resolutely reluctant in their avoidance of risky startups

The venture-capital industry is facing an embarrassment of riches. Venture firms have a staggering $84 billion in their coffers to invest, a near-record amount. And institutional investors are eager to give them more dough, anticipating that the tech industry will regain its financial luster. The signs are promising: Technology stocks are on the rise, and a handful of tech companies, including FormFactor (FORM) and Netgear (NTGR), have gone public recently. "Even today, after all the problems the business is having, there are tons of institutional investors clamoring to get into the venture business," says Joshua Lerner, a professor at Harvard Business School. "This is what we call the potential overhang."

But the flood of money could turn out to be more bane than boom. For starters, the seemingly endless supply of resources could lead venture-capital firms to throw good money after bad, keeping alive faltering companies instead of shutting them down. VCs also are chasing bigger and bigger deals, putting increasing amounts into later-stage projects and even leveraged buyouts. These investments may use up big chunks of capital, but they hardly fit the high-risk profile for which venture firms are traditionally known.

Indeed, venture-capital firms seem more risk-averse than ever when it comes to backing new tech companies. Just 21% of all venture deals done in the 18 months through June were in early-stage investments, according to Thomson Venture Economics. That's the lowest percentage since 1977, and it's way below the average 34% of the past three decades. When the VCs do make investments, they tend to be concentrated in a handful of favored industries, driving up the valuation of deals. All this could hurt the long-term performance of the industry. "The venture-capital industry is still going through dramatic restructuring," says Jesse Reyes, a vice-president at Thomson Venture Economics. "If it takes until 2007 before all the pain is washed out, I wouldn't be surprised."
SURELY OF CAUTION. Certainly, the returns that VCs are reporting to their investors these days are plenty painful. One-year returns sank to -29% as of Mar. 31, while three-year annualized returns were -17%, says Thomson Venture Economics. This for an industry that averaged annual returns of 16.6% over the past 20 years.

Still, too much caution could be costly. If the VCs focus their time and money on later-stage deals, they may not have the resources for big, new ideas. Experts say some of the most innovative, swing-for-the-fences business plans could suffer significant delays or, worse, never get off the ground. "In certain periods things have gotten so bad that even really good things are not financed," says Harvard's Lerner, referring to the mid-1970s, when the number of venture-backed startups plunged. "If things get worse, we have grounds to be really worried."

Case in point: ThinkingVOICE Networks. The Mountain View (Calif.) telephony startup has technology designed to improve customer service by more easily linking up buyers and sellers over the Internet. The company's founder, Don Christopher Cullinane, is a successful, experienced entrepreneur. He sold his last company in 1999 for $130 million. Despite his track record and a promising idea, Cullinane can't get VC backing for his brainchild yet. So he has bootstrapped the project himself, aiming to prove his concept before going back to the VCs. Sellers on eBay (EBAY) are using his product, but he has scaled back his plans for ThinkingVOICE, focusing on niche markets instead of broader applications. "We've taken what was originally a very big concept and throttled it back," says Cullinane.

NARROWED FOCUS. The more frugal nature of VCs isn't necessarily a bad thing. And just because VCs are more skittish about riskier investments doesn't mean some early-stage deals aren't getting the green light. Some $1.6 billion has gone into such deals so far this year, putting the industry on its 1995 pace.

Much of that money is chasing the few choicest deals. New VC investments have been concentrated in just a few sectors, such as wireless networks, security software, and storage, that look like potential winners. One of the lucky few: RFco, a Los Gatos (Calif.) startup that raised $17 million earlier this year in little more than 30 days. RFco is developing chips for the wireless market that, among other things, would allow cell phones to tap into any available wireless frequency and considerably improve performance. It could have raised even more money because many VCs consider its technology highly promising. "This is the first new thing in radio in 85 years," boasts RFco's CEO, Richard Forte. "I could have raised four times the money."

With so much money focused on a few areas of technology, some question whether a new bubble is forming. "I'm nervous that this will result in mindless competition," warns Roger B. McNamee, a veteran tech investor now with Silver Lake Partners, a high-tech buyout fund in Silicon Valley. "The mismatch of capital and opportunity is a
real threat."

SLOW REHAB. There is evidence that startup valuations are starting to rise. IronPort Systems Inc., an upstart in San Bruno, Calif., that provides filtering and security technology for e-mail systems, saw its valuation nearly double within one year, from $16.5 million in June, 2002, to $31.5 million in July. Whether or not such an increase is merited won't be known until the company either goes public or is acquired. But critics say that it's an example of how the pressure VCs are under to invest is driving up prices. "When VCs find a good deal, they're willing to pay up for it," says T. Bondurant French, CEO of Adams Street Partners in Chicago, a large institutional investor. "We see companies where we think the right price is $42 million, and it gets done at $55 million."

For companies such as RFco and IronPort, that's good news. But for the venture industry at large, it may be another symptom of the lingering hangover. That's quite a price to pay for what was the greatest boom in venture history. "The venture industry may be out of the hospital, but it's still in rehab," says Jonathan D. Feiber, a partner at Silicon Valley's Mohr Davidow Ventures. And it looks like it may be there for some time to come.

By Linda Himelstein in San Mateo, Calif.