8 Trends In Venture Capital 2012

Law360, New York (June 04, 2012, 3:43 PM ET) -- Over the past decade, the venture capital industry has experienced significant change. This change has accelerated since the financial meltdown of 2008. This change has manifested itself again in the first quarter of 2012 where venture capitalists invested $5.8 billion in 758 deals in the first quarter of 2012, according to the Money Tree Report from PricewaterhouseCoopers and National Venture Capital Association. This represented a decrease in dollars of 19 percent and number of deals of 15 percent compared to fourth quarter of 2011, when $7.1 billion was invested in 889 deals.

A number of pundits have claimed that the venture capital industry is “broken” and needs a new business model. Whether this is true remains the subject of debate. However, few doubt that the venture industry is changing. To comprehend the evolution of this critical industry, one should understand eight current trends in venture capital.

1) Radical Change

The change in the venture industry itself has taken a number of forms. There has been a contraction in the number of venture funds and a decrease in fund size. According to Thomson One, in 2001, there were approximately 1,200 venture funds. Today there are approximately 600 funds.

According to VentureSource, the number of active firms making at least five investments in the last 12 months is less than 300. Venture capital is a challenging business and, according to the research firm Prequin, the investment returns for the last decade have been negative. Although there is some evidence that institutional investors are softening their negative view of venture capital, institutional investors that have backed venture funds have suffered major losses and reduced allocations to venture capital. Accordingly, many venture firms could not raise new funds and left the industry.

In 2010, 125 funds raised $11.2 billion. This is a steep drop from the $24.6 billion raised by 190 funds in 2008. However, the more recent picture is mixed. Dow Jones reported that 42 U.S. venture funds raised $7 billion in the first quarter of 2012, a 35 percent increase over the $5.2 billion raised in the fourth quarter of 2011. Thomson Reuters reported a decline in the fundraising activity.

Averaging the two studies shows fundraising is afloat but the number of funds raising money continues to be low. More troubling is that the top five funds raised accounted for 75 percent of the total funds raised. In addition, the size of venture funds has decreased. Summit Partners and Charles River Ventures recently closed funds of only $375 million. Part of this trend is due to the inability to raise capital as described above but more so to the fact that the large fund size proved to be an inefficient business model for early and mid-stage venture investing. In short, it has been very difficult to scale a venture firm.

2) The Era of Cheap

Historically, VCs looked for a strong executive team, operating in a large, rapidly growing market, addressing a critical need, with valuable intellectual property and some customer acceptance. However, since 2001, VCs have placed “capital efficiency” high on the list of investment criteria. Capital efficiency refers to the amount of funds that are required for the enterprise to reach profitability. The lower the number, the more attractive the investment.

According to the Money Tree Report for the first quarter of 2012, computer software and Internet companies were the top draw for venture capital attracting $1.4 billion in the quarter. Although this is a 3 percent decrease over the amount raised in the fourth quarter of 2011, it was eighth consecutive quarter in which Internet companies attracted in excess of $1 billion in venture capital.

Many of these companies can develop and launch a product or service into the market for a few hundred thousand dollars and quickly determine demand. This phenomenon is being referred to as the “Era of Cheap.” Those getting traction can be sold quickly for high returns or raise venture funding and look for the “home run.” Instagram Inc, which Facebook purchased for $1 billion in April 2012, is a classic example.

3) Rise of the Angels

Angel investing has been strong the past three years. Angel investors typically provide seed financing in the amount of $50,000-$1.5 million. According to the University of New Hampshire Center for Venture Research, angels invested $19 billion in 55,300 companies in 2008, $18 billion in 57,200 companies in 2009 and $20.1 billion in 61,900 companies in 2010.

The return of angel investing since the dot-com bust has been driven by a number of factors, namely the increase in the number of entrepreneurs who sold their companies and are now looking to invest; the proliferation of organized angel investor groups along the lines of the famous “Band of Angels” in Silicon Valley and, as mentioned above, the modest cost to launch Internet or software application based companies. According to the Angel Resource Institute, in 2011 there were approximately 265,000 angel investors and angel groups have proliferated throughout the U.S. with 32 in California alone.

4) Re-Emergence of Corporate Venture Capital

Over the past 20 years, corporate venture capital, corporations that establish divisions that invest the corporation’s money in emerging companies, has dramatically risen and fallen. In general, corporate venture capital declined dramatically as a result of the financial meltdown of 2008. Since then, it has rebounded significantly with corporate venture investment increasing from $1.4 billion in 2009 to $2.0 billion in 2010 and $2.3 billion in 2011.

According to the Money Tree Report, in 2011 corporate venture capitalists participated in 15 percent of all venture capital deals investing in 551 deals. Another indication of corporate venture activity is that the number of corporate investors who are members of the NVCA has grown from 50 to 62 members in the past year and now comprises 7 percent of the total membership.

Corporate venture investment seems more focused in industries with large capital requirements such as clean tech and biotech, which accounted for 23 percent and 16 percent of the corporate venture investment respectively in 2010 and 2011. For example, biopharma companies are eager to cut R&D spending and fill the pipelines of pharmaceuticals in development. In the next three years, drugs accounting for $21 billion in sales will lose their patent protection. These companies have recognized their weakness in early stage R&D. As a result, companies such as Merck, GlaxoSmithKline and Johnson and Johnson are entering the venture market.

5) Deal Terms

Although there has been substantial change in the venture industry, deal terms are stable but slightly favoring the investor. According to the Fenwick & West Trends in Terms of Venture Financings, the number of deals with a 1X-2X liquidation preferences remain the vast majority of deals. While a 3X or higher preference are a small minority of deals.

According to a study by WSGR, in pari passu liquidation preferences increased from 42 percent of series B and later rounds in the fourth quarter of 2011 to 55 percent in the first quarter of 2012. Between 2007 and 2010, well over half of the deals had participating preferred stock. In 2008, approximately 55 percent of the deals had a cap on such participation rights. The percentage increased to 60 percent in 2009 and fell to 43 percent in 2011.

In the first quarter of 2012, 29 percent of the deals had no cap on the liquidation preference. Dividend preferences have stayed uniform over the past several years with provisions for cumulative dividends appearing in less than 10 percent of the deals. Weighted average anti-dilution protection was used in over 90 percent of the venture deals closing in 2007 through 2010.

According to a study by WSGR, 94 percent of the deals over in the last quarter of 2012 used broad-based weighted average anti-dilution. In the past three years approximately 10 percent of the deals had ”pay-to-play” provisions and between 20 percent and 24 percent of deals had mandatory redemption provisions. According to the WSGR study, in the first quarter of 2012, 26 percent of the deals had a redemption provision. These numbers are consistent with historic norms.

6) Valuations

The landscape for valuations is complex. As the Era of Cheap and challenging employment environment lead more to more startups, the supply has increased putting downward pressure on valuations. According to VentureSource, valuations fell in 2010 to the lowest level since 2005. In fact, on an inflation adjusted basis, early stage valuations are at a 20-year low.

On the other hand, late stage valuations have increased since 2003. This is primarily due to companies staying private longer giving the financial metrics more time to mature. Valuations are also differ by sector, other than the Internet sector in which valuations have risen, valuations have fallen across a wide variety of sectors, such as communications and media -20 percent, semiconductor -77 percent and hardware -93 percent.

In addition, as a result of the Affordable Health Care Act, the most challenging U.S. Food and Drug Administration in history and uncertainty over Medicare reimbursement, valuations of biotech and medical device companies have fallen. However, generally for the first quarter of 2012, the average valuation of a Series A round (other than angel deals) was $9.2 million, compared with $8.0 million in the fourth quarter of 2011 and $5.6 million in third quarter of 2011.

7) Rise of Secondary Exchanges

Over the past several years, the capital markets have witnessed the emergence of secondary exchanges for the transfer of privately held shares of venture-backed companies. Led by SharesPost, Second Market and Financial Xpert Inc., these secondary exchanges are operating in uncharted waters. The entire concept faces securities law hurdles and the U.S. Securities and Exchange Commission is watching this phenomena closely.

Facebook accounted for a large percentage of the trading on these secondary exchanges. In anticipation of its IPO, the secondary trading of Facebook shares ended in March 2012. How these exchanges will fare in absence of Facebook is an open question. Interestingly, Second Market reported that issuers were the buyers in 54 percent of the second market transactions but only accounted for 1.7 percent of the transaction proceeds, suggesting that issuers are using Second Market to purchase small amounts of shares to limit their number of shareholders.

8) Schizophrenic IPO Market

Over the past decade, the IPO market for technology companies has been anemic at best. In 2008, only six venture-backed companies went public, followed by nine in 2009. The troubled IPO market seemed to be turning around more recently as IPO activity improved again in the first quarter of 2012. in the quarter, 20 venture-backed companies raised $1.4 billion compared to 10 venture backed IPO’s raising $2.4 billion in the fourth quarter of 2011.

However, the bar for going public remains high and the mixed results of the high-profile IPO’s of Zynga and Facebook are likely to make the situation worse. According to a banker at Canaccord Genuity, the problem with the IPO market is not the lack of supply from companies, it is the lack of demand from the buyer side. The after-market performance of IPOs (especially in life sciences and clean technology) has been dismal. Although intended otherwise, the JOBS Act has the potential to result in even worse after-market performance for new issuers as an onslaught of very early stage companies trying to access the public markets.

Conclusion

Fundraising by venture firms continues to be problematic and likely contributed to the decreased venture investment the last two quarters. Combined with the schizophrenia of the IPO market, the debt crisis in Europe and economic trouble in China, there is no reason to believe that the venture capital market will improve in the short term. Although there has been significant change in the venture industry, more change is on the way. Whatever the outcome, the venture capital industry is a cornerstone of innovation in the U.S. and the country's ability to remain competitive in an increasingly complex world.

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