

The incredible shrinking venture industry

Many VCs believe the business has finally right-sized, but don't place your bets too quickly

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Senior Editor

Many venture capitalists like to think the industry's decade-long bloodletting is coming to an end. Don't be too quick to agree.

More pruning might be on the way, despite a consolidation that has done away with or created zombies out of as many as half of the 1,053 firms active at the height of the dot-com bubble.

It comes down to simple math. The industry continues to invest more than it takes in at a time when capital concentration is putting resources in the hands of a few mega firms.

Sure, distributions and returns are on the rise, as is the venture-backed IPO market. But negative sentiment remains high among LPs, and venture firms at the margin of the business are likely to face questions of survival when they go back for new money.

It is not a surprise that many in solid, prosperous firms sense a period of stability. The pace of investing has steadied at between \$25 billion and \$30 billion, and attractive portfolio exits are becoming more frequent. Startup innovation is exciting and disruptive.

"I feel we're almost all the way through the cleansing, which should result in a very healthy venture ecosystem," said **Adam Marcus**, a managing director at **OpenView Venture Partners**. "Generally it feels like were in a great, steady state."

But here are the startling facts. The industry continues to downsize at a considerable pace. For instance, only 221 U.S. firms invested \$4 million or more in new companies year to date through the first week of December. That's down almost 39% from 2007, when 360 firms made that size investment.

Viewed from a deals perspective, that's just 123 firms backing five or more new companies, off a quarter from 2004, when



Adam Marcus

the number stood at 163.

These numbers come from an analysis of data from the MoneyTree Report, which is assembled by **PricewaterhouseCoopers** and the **National Venture Capital Association**, based on data from **Thomson Reuters** (publisher of VCJ). The report looks at just U.S.-based companies and firms, and VCJ's analysis doesn't include corporate venture arms and most angels.

At the same time, the industry continues to bleed capital. In all but two of the past 15 years, GPs invested more than they raised, according to data from the NVCA and Thomson Reuters. This includes the first nine months of 2013 when venture firms raised \$11.6 billion and invested \$20.8 billion – a gap that widened from 2012.

And there are no signs of relief. GPs write checks for what they see as attractive investment opportunities, but LPs don't. Through the first three quarters of 2013, venture fundraising was down 29% from 2012.

Capital concentration continues at a high level. The top 20 firms raising money through the first week of December captured 57% of the year's fundraising, according to Thomson Reuters. The top 30 firms account for 70% of commitments.

As most GPs know, there are numerous reasons for this broad decline. One is the

2008 financial crisis, which appears to have accelerated the process. But perhaps the most important is the overfunding of the dot-com years and the corresponding plunge in returns. From 1999 to 2005, top-quartile returns have been an unimpressive single digit number.

"There should be no surprise at all," said **DCM** General Partner **Dixon Doll**. "This is not rocket science."

The industry's fate has other causes, as well. One is a direct casualty of the dot-com tragedy – the subsequent collapse of the IPO market. Another is structural change in the venture business itself. With a limited IPO market, the math works better for smaller funds. A portfolio company with a successful IPO can return a substantial portion of a \$150 million to \$300 million fund, not an \$800 million fund.

"It is pretty self evident at the end of the day," said **Bryan Stolle**, a general partner at **Mohr Davidow Ventures**. "You don't want a large fund."

Another part of the structural change is that venture has returned to its cottage industry roots as new avenues open up for entrepreneurs to get funding, platforms like **AngelList**, accelerators such as **Y Combinator** and **Techstars**, and crowdfunding sites such as **Kickstarter**.

The result is that angel investing has taken off, and new smaller firms such as **Foundry Group**, **Felicis Ventures** and **Freestyle Capital** have grown up focused on seed and early-stage investing. They soak up capital that might have gone to traditional VCs.

"In many ways these are the trends that are most fundamentally changing the startup landscape and causing the venture industry to change along with it," said **Seth Levine**, a Foundry Group managing director. "It's causing a bit of what you might call the democratization of capital."

One impact is the "barbell effect" with respect to fund size, Levine said. "We're seeing that play out, with the vast majority of firms raising smaller amounts of money [below about \$200 million] and a small number of mega-funds at the top end."

All this puts enormous pressure on LPs.

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Endowments and foundations that overweighted illiquid assets in 2008 paid a price and they have shifted away from illiquidity since. Many sought the safety of big name firms, which have moved multi-stage and raised large funds.

"I'm pleased that finally the LP universe understands it's a tough business and is more discriminating in how it allocates capital to the space," said **Joe Horowitz**, managing general partner at **Jafco Ventures**. "I think there is less tolerance for poor performers."

Still, with good reason, many VCs believe the consolidation of the past decade has largely run its course. For one, the industry has returned to 0.1% of GDP, where it was from 1985 to 1994, as noted by **Kate Mitchell**, a partner at **Scale Venture Partners**. It was as high as 1% of GDP during the height of the dot-com bubble.

With annual fundraising of \$15 billion to \$20 billion – an appropriate amount for the industry – and the overhang lower, "this is the supply-demand equilibrium we have been looking for," Mitchell said.

As to the disappearance of firms, "I would say it's largely run its course," agreed **Peter Barris**, managing general partner at **New Enterprise Associates**. Barris, whose firm is one of the surviving giants, argues that the capital concentration mirrors that of the financial services industry, which bifurcated into bulge bracket and boutique firms.

"That's what happened to our industry," he said. "It's just taken a longer time."

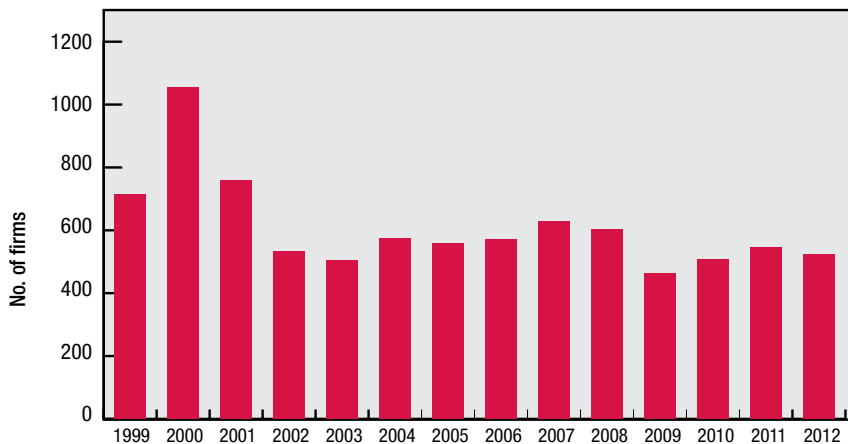
The change comes with one benefit, Barris said. Venture capital has become a global industry, and startups rely on diversified firms with the capital base and knowledge to help them scale.

And yet, it is hard to know for sure. The industry's capital overhang has come down, to \$53 billion last year from \$84 billion in 2008, but remains considerable, perhaps masking the sustainable level of investment activity underneath. With just 123 firms making five or more new investments this year, fewer companies will be in the pipeline to receive follow-on funding over the next couple of years. The universe of later-stage companies could be smaller.

On top of that, fundraising remains stagnant. A recent study by **Probitas Partners** found that 44% of LPs say they simply don't invest in venture capital any more.

The result of all this is both good and bad. Ultimately firms face less deal competition, and startups that once confronted a couple

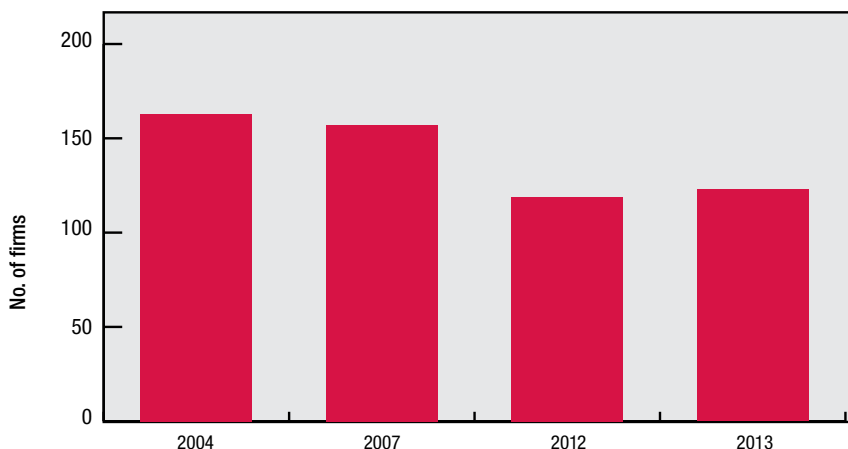
Active venture firms



Source: National Venture Capital Association.

Notes: Active firms invested \$5 million or more annually in MoneyTree deals. The firm total includes corporate venture arms.

Venture firms with five or more new deals per year



Source: Thomson Reuters.

Note: 2013 data is year-to-date through Dec. 6.

of dozen competitors now see three to five and a handful of wannabes.

And good companies receive funding.

"The market for B, C and D rounds is competitive," said **Jeff Richards**, a partner at **GGV Capital**. "There are a lot of \$400 million, \$500 million and \$600 million funds now."

Yet orphaned companies exist in substantial numbers, and second-tier companies that almost always got capital five years ago can expect to see their valuation targets cut in half if they get it today.

"It could be challenging for some of the first-time entrepreneurs who may not have

hit all the milestones they promised," Doll said.

It also will change the way venture firms do business. At **Keating Capital**, consolidation has brought "a narrowing and deepening of relationships with the firms that have the IPO deal flow," said **Timothy Keating**.

More adjustment may be ahead. As to the industry's size, "I would expect you will see further reduction," said Keating.

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COVER STORY

Venture fundraising, 2013

Firm	Year founded	Location	Amount raised (\$M)	No. of funds
Greylock Partners	1965	Menlo Park, Calif.	\$1,016.50	1
Sequoia Capital	1972	Menlo Park, Calif.	\$767.63	2
OrbiMed Advisors LLC	1989	New York	\$699.50	1
Battery Ventures LP	1983	Waltham, Mass.	\$650.00	1
Third Rock Ventures LLC	2007	Boston	\$515.63	1
Accel Partners & Co Inc	1983	Palo Alto, Calif.	\$475.00	1
Matrix Partners LP	1977	Waltham, Mass.	\$450.00	1
Spark Capital	2005	Boston	\$450.00	1
Highland Capital Partners LLC	1988	Cambridge, Mass.	\$425.00	2
Redpoint Ventures	1999	Menlo Park, Calif.	\$400.00	1
Frazier Healthcare	1991	Seattle	\$377.44	1
Softbank Capital	1994	Newton, Mass.	\$321.02	3
Telegraph Hill Partners	2001	San Francisco	\$310.00	1
Scale Venture Partners	1995	Foster City, Calif.	\$300.00	1
Foundation Capital	1995	Menlo Park, Calif.	\$282.00	1
Social+Capital Partnership	2011	Palo Alto, Calif.	\$275.00	1
Atlas Venture Advisors Inc	1980	Cambridge, Mass.	\$265.00	1
5AM Venture Management LLC	2002	Menlo Park, Calif.	\$250.00	1
University Ventures	2011	New York	\$250.00	1
Lux Capital	2000	New York	\$245.00	1
Petra Capital Partners LLC	1996	Nashville, Tenn.	\$230.00	1
Grotech Ventures	1984	Hunt Valley, Md.	\$225.00	1
Foundry Group LLC	1996	Boulder, Colo.	\$225.00	1
FirstMark Capital LLC	1997	New York	\$225.00	1
Technology Crossover Ventures	1995	Palo Alto, Calif.	\$205.00	1
Revolution Ventures LLC	2000	San Diego	\$200.00	1
Drive Capital LLC	2013	Columbus, Ohio	\$181.00	1
Beringea LLC	1988	Farmington Hills, Mich.	\$180.00	1
Morgenthaler Ventures	1968	Menlo Park, Calif.	\$175.00	1
Newspring Capital	1999	Radnor, Penn.	\$170.00	1
Volition Capital LLC	2010	Boston	\$170.00	1
The Carlyle Group L.P.	1987	Washington, D.C.	\$162.84	1
Blumberg International Partners LLC	2000	San Francisco	\$150.00	1
Ignition Partners	2000	Bellevue, Wash.	\$150.00	1
Third Security LLC	1999	Radford, Va.	\$135.00	2
Javelin Venture Partners	2008	San Francisco	\$125.00	1
Spring Lake Equity Partners	1994	Boston	\$122.25	1
Sigma Prime Ventures LLC	1969	Boston	\$115.59	1
HighBAR Ventures	1995	Palo Alto, Calif.	\$114.00	1
Wing Venture Partners LP	2013	Menlo Park, Calif.	\$111.00	1
Pelion Venture Partners	1986	Salt Lake City	\$110.85	1
Lead Edge Capital	2013	New York	\$105.90	1
Icon Venture Partners LP	2013	Menlo Park, Calif.	\$100.00	1
Foresite Capital Management LLC	2011	San Francisco	\$100.00	1
The Westly Group LLC	2007	Menlo Park, Calif.	\$97.00	1
Ascension Ventures	2001	Clayton, Mo.	\$75.00	1
Silverton Foundation	2000	Austin, Texas	\$75.00	1
S3 Ventures	2006	Austin, Texas	\$75.00	1
Causeway Media Partners LP	2013	Boston	\$73.49	1
SWaN & Legend Venture Partners	2012	Leesburg, Va.	\$70.00	1
Sandbox Industries LLC	2003	Chicago	\$68.29	2
Venture Investors L L C	1982	Madison, Wisc.	\$65.00	1
SJF Ventures	1999	Durham, N.C.	\$54.80	1

Venture fundraising, 2013

Firm	Year founded	Location	Amount raised (\$M)	No. of funds
Enertech Capital	1996	Conshohocken, Penn.	\$51.90	1
Hatteras Venture Partners	2000	Durham, N.C.	\$50.11	1
Altira Group LLC	1996	Denver	\$49.30	1
Origin Ventures	1999	Northbrook, Ill.	\$47.00	1
Noro-Moseley Partners	1983	Atlanta	\$46.97	1
Arthur Ventures	2008	Fargo, N.D.	\$45.27	1
NaviMed Capital Advisors LLC	2011	Washington, D.C.	\$44.80	1
500 Startups, L.P.	2010	Mountain View, Calif.	\$44.07	1
Rock Spring Ventures LP	2011	Bethesda, Md.	\$41.42	1
Partech International	1982	San Francisco	\$40.58	1
Freestyle Capital	2009	Mill Valley, Calif.	\$40.18	1
Upfront Ventures	1996	Los Angeles	\$40.00	1
Draper Triangle Ventures	1999	Pittsburgh	\$40.00	1
Initialized Capital	2013	Brooklyn, N.Y.	\$39.15	1
Storm Ventures LLC	1997	Menlo Park, Calif.	\$38.33	1
Detroit Venture Partners LLC	2010	Detroit, Mich.	\$38.00	1
Glynn Capital Management LLC	1970	Menlo Park, Calif.	\$37.07	1
Emergent Medical Partners LP	2007	Portola Valley, Calif.	\$37.00	1
Romulus Capital LLC	2008	Cambridge, Mass.	\$36.24	1
Arcus Ventures	2007	New York	\$35.63	1
Great Oaks Venture Capital LLC	2005	New York	\$35.50	1
Homebrew LLC	2013	San Francisco	\$35.00	1
Pharos Capital Group LLC	1998	Dallas	\$34.44	1
Bowery Capital	2013	New York	\$33.00	1
Collaborative Fund	2010	New York	\$31.64	1
2x Consumer Products Growth Partners LP	2007	Chicago	\$31.30	1
Sanderling Ventures	1979	San Mateo, Calif.	\$30.00	1
SparkLabs Global Ventures	2013	Palo Alto, Calif.	\$30.00	1
METAMORPHIC VENTURES L L C	2006	New York	\$29.85	1
Atlas Peak Capital	2013	San Francisco	\$28.91	1
Novaquest Infosystems Inc	2009	Raleigh, N.C.	\$27.97	1
Illinois Innovation Accelerator Fund	2007	Chicago	\$27.95	1
YL Ventures GP Ltd	2008	San Francisco	\$27.50	1
Signal Peak Ventures	2011	Salt Lake City	\$26.00	1
Prolog Ventures	2001	Saint Louis	\$26.00	1
Five Elms Capital	2007	Prairie Village, Kansas	\$25.86	2
Wave Equity Partners	2009	Boston	\$25.00	1
Ptv Sciences	2003	Austin, Texas	\$24.75	1
Aphelion Capital LLC	2005	Mill Valley, Calif.	\$23.00	1
TechOperators LLC	2008	Atlanta	\$22.62	1
Mountain Group Capital LLC	2002	Nashville, Tenn.	\$21.45	1
Eagle Cliff Partners LLC	2013	San Francisco	\$20.10	2
Incycyte Venture Partners LLC	2009	San Antonio, Texas	\$20.01	1
Fenix Venture Capital Inc	1989	San Jose, Calif.	\$20.00	1
Merus Capital Investment	2007	Palo Alto, Calif.	\$17.28	1
Union Bay Capital	2012	Seattle	\$16.18	1
Amplify Partners LP	2012	Cambridge, Mass.	\$16.03	1
Liberty City Ventures	2012	New York	\$15.00	1
MentorTech Ventures LLC	2005	Philadelphia	\$13.49	1
Eniac Ventures, L.P.	2009	New York	\$12.90	1
Innovation Works Inc	1999	Pittsburgh	\$12.00	1

YEAR IN REVIEW

Venture fundraising, 2013

Firm	Year founded	Location	Amount raised (\$M)	No. of funds
Illuminate Ventures	2009	Oakland	\$11.46	1
Tennessee Angel Fund LP	2003	Nashville, Tenn.	\$11.41	1
Commonangels	1998	Lexington, Mass.	\$11.15	1
BOLDstart Ventures Management	2010	New York	\$10.72	1
TTV Capital LLC	2000	Atlanta	\$10.65	1
Sierra Ventures	1982	Menlo Park, Calif.	\$10.00	1
Forte Ventures	2012	Atlanta	\$10.00	1
SAIL Capital Partners LLC	2002	Irvine, Calif.	\$10.00	1
Cottonwood Capital Partners LLC	2009	El Paso, Texas	\$10.00	1
FreshTracks Capital	2000	Shelburne, Vt.	\$10.00	1
Unitus Seed Fund LLC	2012	Seattle	\$9.85	2
Sovereign's Capital	2012	Durham, N.C.	\$8.80	1
IDEA Fund Partners	2003	Durham, N.C.	\$8.15	1
CincyTech	2001	Cincinnati	\$7.90	1
Allos Ventures LLC	2010	Carmel, Ind.	\$7.00	1
WindSail Ventures LLC	2009	Boston	\$7.00	2
Excelerate Health Ventures LLC	2013	Durham, N.C.	\$5.10	1
Crosslink Capital Inc	1989	San Francisco	\$4.74	1
Oregon Angel Fund	2009	Portland, Ore.	\$4.50	1
Resonant Venture Partners	2010	Ann Arbor, Mich.	\$4.14	1
Divergent Ventures LLC	2003	Seattle	\$3.95	1
Core Ventures Group LLC	2013	Palo Alto, Calif.	\$3.75	1
Blue Chip Venture Co	1990	Cincinnati	\$3.75	1
Huron River Venture Partners LLC	2010	Ann Arbor, Mich.	\$3.50	1
Queen City Angels	2003	Cincinnati	\$3.49	1

Venture fundraising, 2013

Firm	Year founded	Location	Amount raised (\$M)	No. of funds
Hyde Park Venture Partners	2011	Chicago	\$3.47	1
Seven Peaks Ventures	2013	Bend, Ore.	\$3.13	1
BELLE Capital Management LLC	2011	Auburn Hills, Mich.	\$3.10	1
Peate Ventures LLC	2013	Ventura, Calif.	\$3.03	1
Rembrandt Venture Partners	2004	Menlo Park, Calif.	\$3.00	1
First Round Capital	2004	Philadelphia	\$3.00	1
Peninsula Ventures	2001	Redwood City, Calif.	\$2.30	1
Michigan eLab	2013	Ann Arbor, Mich.	\$2.25	1
Psilos Group Managers LLC	1998	New York	\$2.23	1
Vodia Ventures LLC	2013	Concord, Mass.	\$2.13	1
Rochester Angel Network	2005	West Henrietta, N.Y.	\$2.05	1
Stanmore Medical Investments	2013	West Palm Beach, Fla.	\$2.00	1
Aristos Ventures	2013	Dallas	\$2.00	1
Western Technology Investment	1980	Portola Valley, Calif.	\$1.90	1
FundersClub Inc	2012	San Francisco	\$1.63	2
DreamIt Ventures	2007	Bryn Mawr, Penn.	\$1.60	1
Crestlight Venture Productions LLC	2012	Santa Clara, Calif.	\$1.29	1
Armory Square Ventures Manager	2013	Skaneateles, N.Y.	\$1.00	1
Skylands Capital LLC	2005	Niwot, Colo.	\$0.80	1
Strong Ventures LLC	2012	Los Angeles	\$0.72	1
MAYWIC Select Investments LP	2013	Cincinnati	\$0.55	1
Cultivation Capital	2012	Saint Louis	\$0.38	1
Merlin Nexus	2001	New York	\$0.37	1
Gaston Capital Partners LP	2013	Gastonia, N.C.	\$0.05	1

Source: Thomson Reuters.

Notes: Data is for U.S.-based firms, year-to-date through Dec. 6.

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