On the Flying Bridge

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The Slog Continues…

Last week the National Venture Capital Association (where I am on the Executive Committee) and Thomson Reuters announced the 2Q12 fundraising data for venture firms – don't worry, you are excused if you did not see the results. Not pretty. The data has some potentially troubling implications for entrepreneurs, not just GP's.

While the headline looked encouraging with $5.9BN raised this past quarter, which ironically compares very favorably to many of the recent quarters since the Great Recession started over four years ago, it is the details which are more disturbing. If you annualized last quarter's pace you might conclude that the VC industry is back to raising around $25BN per year – which is about how much we as an industry invest each year. But as you can see in the chart below, the number of firms which raised capital (38) is very much a low water mark and most of the capital went to a small number of firms.

Fundraising by Venture Capital Funds

Year/Quarter	Number of Funds	Venture Capital ($M)
2008	212	25,179.1
2009	163	16,335.8
2010	173	13,559.2
2011	182	18,575.1
2012	82	11,173.5
2Q'10	49	2,100.8
3Q'10	56	3,688.4
4Q'10	50	3,735.2
1Q'11	47	7,556.7
2Q'11	45	2,609.4
3Q'11	65	2,140.5
4Q'11	53	6,268.5
1Q'12	49	5,264.4
2Q'12	38	5,909.1

So why am I so disturbed by these results? Couple of high/low lights in the detailed data:

- Of the 38 firms which successfully raised new funds this past quarter, only five firms (NEA, IVP, Lightspeed, Kleiner, Mithril (Peter Thiel)) accounted for nearly 80% of the total dollars raised

- Of the top five funds raised, four were at least the ninth fund that firm had raised
- Notwithstanding that NEA is headquartered in Baltimore (with a very significant and successful Silicon Valley presence), the other firms in the top five are based in the Valley – which may raise concerns over time about the geographic diversity of how innovation is funded in this country
- 10 of the 38 funds were from new managers, which also is the lowest number of new venture managers since 2Q09 – which very much underscores that LP's have largely turned their collective backs on new venture firms trying to get into the market
- 14 of the 38 firms raised funds which were less than $10.5MM in size each; these firms raised a total of $104MM, which is less than 5% the size of the largest fund raised by NEA ($2.1BN)
- The median fund size was $11.5MM
- Many LP's are concluding that the optimal size venture fund in this environment is "a few hundred million dollars" but as funds size shrink, more capital intensive industries like biotech and cleantech will be increasingly out of favor
- When I stare really hard at the list of funds, many of their names suggest that they are really annex funds or small follow-on investment partnerships of existing funds which arguably overstates the number of new funds raised
- And what the data does not show is how long these funds took to be raised – that is a real barometer of the health of the VC industry

Having said that, though, the venture industry has a marvelous ability to re-invent itself in the face of poor returns and lack of liquidity, as we are seeing in real time with new creative investment models (micro-VC, super angels, etc). Notwithstanding that observation, the VC industry is characterized by both high barriers to entry and barriers to exit, that is, it can be hard to get in and for many firms that have raised multiple funds, most times it is hard to be pushed out!

But what is most disturbing for me is that the concentration of capital in fewer and fewer hands operating with very large venture funds will make it meaningfully more difficult for companies to be funded. And I am not simply referring to raising your first $500k seed round to build an initial **product**, which there appears to be no shortage of today, but raising more meaningful dollars to build your **company** (which still takes real money).

We are in an environment where too many "look-alike" companies have been seeded with quite modest amounts of capital, and when they come back to raise their first institutional round, those entrepreneurs will be surprised by the relative paucity of Series A/B/C VC firms which are actively investing.

So what is a CEO to do? Be hugely capital efficient and get out there now and start meeting as many VC firms as you can.

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The Slog Continues (cont'd)...

So one final thought...something I have been wrestling with for some time now is how many venture firms can reliably, predictably and on their terms raise a new fund in this environment? Tough question to answer but the data may shed some light.

According to the NVCA Yearbook 2012 there were 842 VC firms in the US at the end of 2011 which have raised capital in the past eight years; of that cohort, 526 firms were deemed "active" – which means they made investments totaling $5 million that year (frankly, a pretty low bar). Interestingly, at the end of 2011, there was approximately $197 billion under management in the US venture industry. Also of note there were 1,012 firms in 2006 so the industry lost 170 firms (or 17%) over the past five years; that same year there was $288 billion under management, which means from a capital managed perspective the industry shrunk by 32% over that same five-year period.

So this is what is so potentially daunting. This past quarter there were 10 firms which raised funds larger than $100 million, which I would deem as a threshold to be material to the overall industry. If this past quarter is representative of the new reality then, and firms raise new funds every four to five years, might one conclude that there is only room for only 160 – 200 firms? Are we looking at an industry that may contract by another 50% – 75% in terms of number of firms?

More numbers. The median fund size of those top 10 funds raised last quarter was approximately $350 million; across those same 160 – 200 firms that would be $56 – $70 billion raised over the next four to five years. Does that start to suggest where we are heading and how large the VC industry will be? The last time the VC industry was less than $100 billion was in 1998 ($91 billion managed).

Undoubtedly this is too dark a picture. We are investing in a time of unprecedented innovation which will drive superior investment performance. As returns and liquidity come back, LP's will be drawn back to the VC asset class – but the analysis is thought provoking nonetheless.

What do you think? What percentage of firms today can raise a fund on their terms? 5%? 10% 25%?