Down year ends on an up note
By Tam Harbert
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This year's slight rise in venture capital funding reminds Mark Jensen, national director of venture capital services for Deloitte & Touche, of the title of a 1960s-era book: Been Down So Long It Looks Like Up to Me. Nobody's predicting a return of the tsunami of investment that crested in the boom times of 2000. Rather, they are hoping for sane, smart investing in companies with products, customers and revenue.

This has been a year when VC funding hit bottom and gradually started to recover. It reached a five-year low of $4 billion in the first quarter, then increased to $4.3 billion in the second quarter and stayed relatively stable at $4.2 billion in the third quarter, according to The MoneyTree Survey, conducted jointly by PricewaterhouseCoopers, Thomson Venture Economics and the National Venture Capital Association.

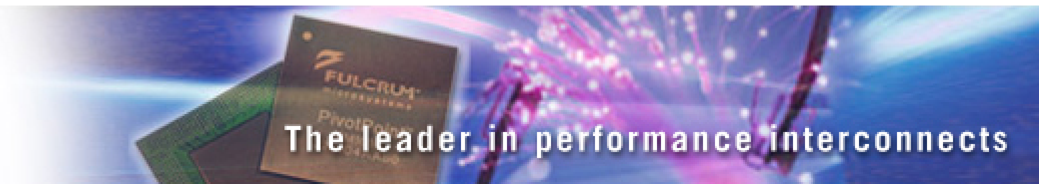
The industry is starting to return to a normal, sustainable level of activity, says Jensen. It is similar to the level of investment in 1997, when VCs were investing between $12 billion and $15 billion a year and averaging 600 to 900 deals a quarter. The companies that are receiving money today have customers and revenue. That's a far cry from the bubble days, when "if it sounded like a good idea, VCs were throwing a term sheet at them," says Todd Jerry, a partner at Anthem Venture Partners.

Although VC dollars are no longer flowing like a river, good companies are still getting funded, albeit at lower levels. Valuations of venture-funded companies have fallen dramatically, and entrepreneurs have had to adjust. Median premoney valuation has dropped from a record high of $29.8 million in the first quarter of 2000 to $8.7 million in the second quarter of this year, according to VC research group VentureOne. That's comparable to valuations in 1995. "If the valuations go any lower, the investors are going to be buying a significant amount of these companies and it just won't make sense for the entrepreneurs," says John Gabbert, vice president of worldwide research at VentureOne. Instead, entrepreneurs will just wait.

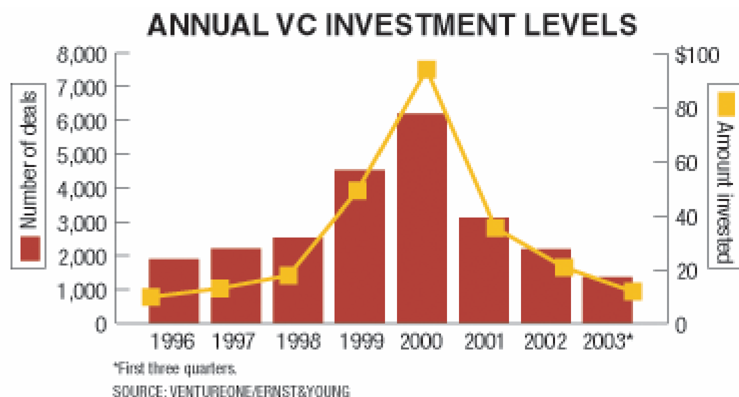
They have gotten used to waiting. The time between financing rounds today is 22 months, compared to 11 months in 2000, says Gabbert. Entrepreneurs "are getting less money, and they are making it last longer." VCs today are also taking their time, doing extended due diligence on potential investments, says Jerry. In fact, "a lot of the fundings in the last quarter are for companies that have been in stealth mode at a VC firm for a long time," says Jensen.

And entrepreneurs must give up a greater percentage of their company in return for VC money. In the second quarter, investors took a median ownership of more than 50 percent in first-round financings and a median ownership of 39 percent overall. That's the highest level in a decade, according to VentureOne.

What's more, VCs won't pony up much, even if the company has a proven technology and a solid business plan. Entrepreneur Bob Nunn learned this when his company, Fulcrum Microsystems, raised $14 million in its third round of funding this year. Fulcrum, a fabless chip-maker, has developed and validated its technology,



manufactured some evaluation chips and has a solid business plan. "But they still treated us like an early-stage company," says Nunn, president and CEO of Fulcrum. The VCs told him, "You need to have revenue before we're going to invest more money."



The downturn has caused VCs "to expect some of the elements of a later-stage deal in an early-stage deal," says Jerry. He notes that somewhat unfairly, VCs expect even early-stage companies to have revenue. That's because in this environment, "investors are not being rewarded for investing early and helping validate the technology and build a business plan," he says.

"Later-stage investors are getting a very good deal," says Nunn, because they are finding companies with validated technology, good management teams and valuations that are nevertheless still low.

VCs today are looking for "a much higher level of capital efficiency," says David Spreng, managing general partner at Crescendo Ventures. In 1999 VCs could spend hundreds of millions of dollars to build a company, because a sale or an IPO could bring in more than $1 billion. Today, $120 million is the more common exit price, so a VC's total investment is going to be only $25 million to $30 million, he explains.

With both the IPO and M&A markets on the upswing (see "IPO market shows signs of life," November 2003), VCs might start anteing up a little more. The median value of merger and acquisition transactions has also increased steadily this year, from $10 million in the first quarter to $26.6 million in the third quarter, says VentureOne. "As we get a more vibrant exit market," says Spreng, "we'll start seeing more startups and early-stage companies get funded."