Management 425 Course Pack

Brad Leve

Chapter 5
The History of Venture Capital

The concept of venture capital is nothing new. It has existed for more than a century. “In the first quarter of the nineteenth century, New England manufacturing was ‘hot’.... Mill profits created an ample supply of venture capital, with activist investors prospecting for opportunities. The most talented young men perceived that a flair for machinery could be a fast track to financial independence.”[1] However, venture capital has evolved and is currently changing again:

> Initially, the venture capital industry grew out of the search by wealthy families for new investments. After World War II John Hay Whitney invested $10 million to form J.H. Whitney & Company. Other families active in the venture capital business were the Rockefellers, Rothschilds, Phippes, Paysons, Rosenwalds, Hillmans, and Bessemers. These wealthy families had an interest in public welfare. They felt they could help humanity by nurturing new ventures. Although personal gain also influenced their decisions to establish venture capital firms, they were driven primarily by a desire to build persons and companies to benefit society.[2]

Investing in oil companies or railways back then was not too different from investing in Internet companies today. Ron Chernow, in his biography of John D. Rockefeller, Sr., writes of the elite Wall Street banker’s preference “to finance railroads and government,” and goes on to say that they “regarded oil refining as risky, untested business, nothing short of outright gambling. Mindful of the extreme fire hazards and the specter of the oil running dry, only a few intrepid souls dared to wager on it.”[3] New industries get created over time, and if you are lucky enough to be born during those periods, vast investment opportunities are available to those who can identify them.

Venture capitalists can be classified into three broad categories. In surfing terms, a “Gandalf” is an older, experienced surfer who is wise in the ways of the wave. The first category, the Gandalf venture capitalists, are the classic surfers of venture capital waves:

> Some historians mark the beginning of venture capital to the 1930s and 1940s, when wealthy families, such as the Vanderbilts, Rockefellers, and Bessemers began private investing in private companies. These so-called angel investors have a following still. One of the first venture capital firms, J.H. Whitney & Company, was founded in 1946 (J.H. Whitney n.d.). They are still in business today, having raised their sixth outside fund, for $750 million, in 2005.[4]

The second category of venture capitalists might be called "Core." A Core is a dedicated surfer who goes out in all conditions, no matter what the air or sea temperature is or how good the waves are. The typical Core surfer is often someone who has been at it a long time and is more often than not quite a good surfer because of his dedication. These would be the modern venture capitalists. The third category of venture capitalists are "Groms." The Groms are the younger surfers who really rip, as a surfer would say.

Gandalf Venture Capitalists

1. Benjamin Franklin (1706-1790). America is the land of opportunity. One of the first true entrepreneurs was Benjamin Franklin. Thousands of entrepreneurs followed Franklin's entrepreneurial footsteps over the years, exemplifying that the United States is a breeding ground for innovation. Benjamin Franklin was a printer, publisher, philanthropist, scientist, and politician. As an entrepreneur, he borrowed money in order to fuel the growth of his printing house. Conscientious of incurring debt, Franklin paid it down. One might view Benjamin Franklin not just as an entrepreneur, but as a serial entrepreneur or one who builds numerous businesses. Franklin was creative enough as an entrepreneur to build additional lines or businesses. For instance, he used his successful printing company for a lucrative newspaper he ran: "My business was now continually augmenting, and my circumstances growing daily easier, my newspaper having become very profitable, as being for a time almost the only one in this and the neighboring provinces. I experienced, too, the truth of the observation, 'that after getting the first hundred pound, it is more easy to get the second,' money itself being of a prolific nature."[5]

2. Thomas Edison (1847-1931). Thomas Alva Edison was born on February 11, 1847, in Milan, Ohio. With only three months of formal education, he became one of the greatest inventors and industrial lenders in history. Edison obtained 1,093 U.S. patents, the most issued to any individual. Edison's greatest contribution was the first practical electric lighting. He not only invented the first successful electric light bulb, but also set up the first electrical power distribution company.[6]

3. Andrew Mellon (1855-1937). One of the godfathers of venture capital was Andrew Mellon. Mellon might have contributed the most of all historical figures in creating the concept of modern-day venture capital:

> He was thought to possess exceptional powers of judgment, both of the character and capacity of the men who sought help and of the feasibility and potential of the schemes which they presented—and he was especially open to the commercial possibilities of emerging science and technology.[7]

Mellon understood growth. In fact, he would take profits and reinvest them back into a company to grow it. He also knew when to exit an investment, such as the Union-Sharon merger, in which he turned a $1 million investment into $42 million plus profit. Today, a 42x (or 42 times your investment) is phenomenal. Railroads, steel companies, and companies were the equivalent of today's technology or Internet companies like Netscape. Mellon also diversified his investments. "This outlook and activity inspired the accumulation of an unusually diverse and widely distributed fortune: Mellon was in this sense a forerunner in the now commonplace practice of portfolio diversification."[8] Just like modern-day venture capitalists, Mellon financed various companies and provided an array of useful services. "He was required not only to devise and oversee so many complex and varied deals, but also to provide funding packages, management assistance, and even technological advice for numerous companies."[9] He identified opportunity and helped mentor companies that showed promise:

> The Pittsburgh Reduction Company was the first significant beneficiary of what would prove to be...Andrew Mellon's extraordinary

> gift [was] for spotting and nurturing outstanding individuals with promising ideas—though in this case, as in others, it would be some time before the promise was abundantly redeemed, both for them and for him. But Mellon was prepared to wait, riding out losses if need be (especially in the early 1890s) and plowing back profits when they came (during the company's first decade dividends were paid out only twice).[10]

Mellon was cognizant of venture capital waves, which helped him become extremely rich. Although involved with many types of businesses, Mellon best capitalized on his acknowledgment of waves within the market through his two most recognized deals, Alcoa and Gulf Oil, which yielded an estimated $128 million in combined profits. Mellon invested in these oil companies at the beginning of a very long and lucrative oil wave.[11] His biographer notes this awareness going back almost two decades before it paid off handsomely on his two key oil investments:

> By the late 1900s and early 1910s, Andrew Mellon's varied business activities had settled into a recognizable pattern that had been developing since the early 1870s: a slump, weathered with difficulty but determination, then a recovery; burgeoning profits for the banks, the Union Trust Company, and many of his companies; one or two undertakings performing below par but with long-term prospects of growth and profit; and one or two just performing below par. To that extent, the years 1907-14 were business as usual, consistent with this latest phase of the economic cycle.[12]

As Secretary of the Treasury, Mellon also made tax cuts that propelled growth. He was a visionary for venture capital. As stated by Lerner and Gompers in *The Venture Capital Cycle,* "Decreases in the capital gains tax rates are associated with greater venture capital commitments."[13] Many fail to see the relationship between taxes and venture capital. Lower taxes are beneficial to small companies. Although he was prescient and correct about his views, Mellon was blamed and prosecuted for tax evasion when the market collapsed.

4. Laurance Rockefeller (1839-1937). Mellon and Rockefeller passed away the same year. Rockefeller was adept at finding and procuring large investors, which is what the most successful venture funds do today. There were others dabbling in what is known today as venture capital, but none took it to the level that Laurance Rockefeller and his decedents did:

> The Rockefeller family, the Whitney family, and the Phipps family were among the first to establish separate venture capital programs. Laurance Rockefeller provided the initial spark in the 1930s. His interest in aviation and his access to capital helped him finance two seminal businesses: Eastern Air Lines and McDonnell Aircraft.[14]

Later, the family set up Venrock to invest in entrepreneurs in a variety of industries. For instance, in 1969, Venrock invested in Intel. Venrock continues the eight-decade Rockefeller tradition of funding entrepreneurs and establishing successful, enduring companies. Having invested $2.5 billion in 442 companies resulting in 125 initial public offerings (IPOs) and 128 merger and acquisition (M&A) exits over the past 41 years, Venrock's investment returns place it among the top-tier venture-capital firms that have achieved consistently superior performance.[15]

5. Henry Phipps (1839-1930). Henry Phipps, one of Andrew Carnegie's partners, founded Bessemer Trust in 1907 to manage his family's wealth.

Bessemer was named for the process he developed in 1856 to convert large amounts of iron into low-cost steel, which he and Andrew Carnegie made a mint using. Bessemer is still active in the venture capital world.

6. Andrew Carnegie (1835-1919). According to J. Bonasia, "The tycoon Andrew Carnegie made a fortune licensing Bessemer's breakthrough in America."[16] Carnegie took an existing technology and leveraged it. He was both innovative and creative. In addition, he was one of the first to arrange a joint venture:

> He [Carnegie] had recapitalized his original sleeping car investment, reorganized two iron companies into the Union Iron Mills, and organized the Keystone Bridge Co. During a nine-month world tour in 1865—part of his continuing quest for social polish — he encountered processes for

> putting steep caps on iron rails, and when he came home, started a company to experiment with the new Bessemer steel (unsuccessfully at this point). As competition between his sleeping car company and the interloper George Pullman heated up, he negotiated a tricky joint venture for a major Union Pacific contract, settled a contentious patent dispute, and merged the two companies in 1870.[17]

Today's Internet has much in common with the initial construction of railroads in the nineteenth century. Jeff Bezos with Amazon is a modern-day Carnegie; he used the Internet and leveraged it selling books through Amazon. Amazon sells many items today, not just books. Bezos launched the revolutionary Kindle in 2007, which might change the way people read books. Both had explosive growth and created new opportunities. As with modern-day venture funds, Carnegie had venture partners until he went out on his own. In doing so, he took the lessons that his mentors had taught him and applied them:

> Only invest in companies you have investigated yourself; only invest in companies about which you have insider knowledge; only invest in companies that sell goods or services for which demand is growing; never invest as an individual, but always with a group of trusted associates who together will own a controlling or dominant interest in the company.[18]

Core Venture Capitalists

1. George Doriot (1899-1987). There were a number of legendary entrepreneurs and venture capitalists after Franklin and Edison, but it was the industrious French immigrant Georges Doriot who pioneered venture capital from Boston with his venture capital firm, American Research and Development (ARD). ARD was very supportive of the company. Among other things, they helped find board members similar to modern day venture firms. Eventually, ARD went the route of an IPO. As evidenced by many successful IPOs backed with venture capital, Digital continued to prosper. "By the summer of 1967, Digital shares hit $80, and in October ARD's stock reached a record of $152, its stake in Digital now worth more than $200 million. Digital was the venture capital industry's first home run, proving that venture capitalists could generate wealth by backing a hot new business."[19] As the godfather of venture capital, Doriot helped finance many growth companies.

> During its 26-year existence, ARD financed 120 companies. Although it was acquired by Compaq Computer in 1998, Digital's rise allowed Doriot to accomplish his ultimate goal of forging a nationwide movement of entrepreneurs. "Doriot was the first one to believe there was a future in financing entrepreneurs in an organized way.. He [and ARD] really created the venture capital community."[20]

Doriot taught and influenced countless entrepreneurs while at Harvard. In fact, a number of the most successful venture capitalists were his students.

2. Edgar F. Heizer, Jr. (1929-2009). According to Trevor Jensen, "Edgar F. 'Ned' Heizer Jr. was a seminal figure in the history of the venture capital industry, whose ability to see beyond the horizon led to successful investments in fledgling companies in fields from computers to pancakes."[21] Edgar Heizer, founder of Heizer Corp., is most famous for backing Amdahl Corp., a database and server production company that is now owned by Fujitsu. He also helped back Federal Express and the International House of Pancakes.

3. Jon Hay Whitney (1904-1982). John Hay Whitney's obituary states: "He founded J.H. Whitney & Company in 1946 as a venture capital company, and its first major investment of $1.25 million in the Spencer Chemical Company doubled in a year."[22] Some have tried to justify Mr. Whitney as the first venture capitalist. He was definitely a shrewd investor with diverse business interests:

> The organization of the venture fund J. H. Whitney & Co. by John Hay (Jock) Whitney in February 1946 is arguably the official starting point of private venture capital in the United States. At the time, Whitney was considered one of the richest men in America, a champion polo player, a horse breeder, and a frequent backer of Broadway shows and Hollywood movies, including *Gone with the Wind.* The idea to raise a private pool of venture capital for venture investing was Whitney's, but it was the execution by Benno Schmidt in his role as managing partner that made the

> fund the most significant of its time.[23]

Whitney owned Whitney Communications, which owned newspapers, televisions stations, radio stations, Aviation Corporation of America, and other investments.

4. Peter Brooke (1925-). Many venture pioneers learned from Doriot, including Peter Brooke, who helped form TA Associates back in 1968. "In 1973, Brooke—who always had an interest in international affairs—brought the VC model to Europe with the founding of Paris-based Sofinnova SA. And in 1974, Brooke left TA Associates to form Advent International."[24] When Brooke started his career, the venture capital market was quite different. Early on, the industry was more localized and not as regulated:

> Today the industry that Brooke helped define is entrenched, global, and the subject of much discussion about possible regulation. To Brooke's thinking, if lawmakers were to move forward with regulation, then they should move forward cautiously. Large private equity investors who can't police their own industry and rely too heavily on debt should be called to account. But over-regulating early-stage venture capitalists—who more than anyone else have the capacity to identify promising companies, move the economy along and create jobs—would be disastrous, he said.[25]

Advent International was originally founded in Boston as a divestiture from TA Associates.

5. Arthur Rock (1926-). Arthur Rock was another venture capital legend. He was involved with starting Fairchild Semiconductor, Teledyne, Intel, and Apple. In 1961 Rock moved to California and formed a partnership with Tommy Davis known as Davis & Rock. Davis & Rock invested $5 million and returned $100 million to investors.[26] Later, he founded Arthur Rock & Company in 1969 to help fund one of the most lucrative companies ever, Apple. In 1975, Arthur Rock invested $1.5 million in the start-up Apple computer, which reached a value of $100 million after the IPO in 1978.[27] As of November 20, 2009, Apple's market cap was approximately $180.3 billion.

6. Eugene Kleiner (1923-2003) and Tom Perkins (1932-). Eugene Kleiner and Tom Perkins are best known for their prowess in the technology space. In 1972, the two launched one of the industry's most successful venture capital organizations, now known as Kleiner Perkins Caufield & Byers.[28] Kleiner Perkins Caufield & Byers's portfolio consists of many leaders such as AOL, Amazon, Genentech, Intuit, Google, and Sun Microsystems. Kleiner Perkins has excellent timing as to when to invest in growth companies and when to exit. Many venture firms were not active in 2009, but Kleiner Perkins appeared to be one of the most active. The firm is a leader with regards to investing in Cleantech. Venture-capital firms are dedicating enormous amounts of money to green companies. Kleiner Perkins serves as a benchmark for anyone investing in venture capital.

7. Richard Kramlich (1935-). New Enterprise Associates (NEA) was founded in 1978 by Dick Kramlich, with approximately $16.5 million. One of NEA's most notable deals was in 1986 with Silicon Graphics, which went public in a $22 million IPO. Ten years later they had UUnet, which went public at $415 million in the IPO and was acquired shortly after by Worldcom for $2 billion. Offices were set up in Washington, Baltimore, and Menlo Park, California. Baltimore was selected as a location partially because of its proximity to Alex. Brown, which took many technology companies public, including Microsoft, America Online, Amazon, and eBay. NEA worked with Alex. Brown, which was the number-one venture-backed IPO firm out of every investment firm or bank on Wall Street for many years. In 2000, NEA closed its tenth fund at $2.3 billion, which made NEA the largest-funded, early-stage venture-capital firm nationwide.

8. Don Valentine (1943-). One of the most legendary venture capitalists of all time is Don Valentine. Valentine is the founder and general partner of Menlo Park, California-based Sequoia Capital. Valentine is not just a wave rider, he is the equivalent of the individual who invented the surfboard. Sequoia invested $2.5 million in Cisco in 1987, the year the market crashed. Like many successful venture capital deals, Cisco did quite well after it received funding in a dismal market: "Valentine became deeply involved at Cisco, serving as chairman from 1986 to 1995. In mid-1988 he brought in John Morgridge as CEO, and in two years the stock started on its 81,900% stratospheric ride." He also helped finance Oracle, Apple, LSI Logic, Electronic Arts, and many others. Early in his career, he met Gordon Moore and Robert Noyce, who later founded Intel. Sequoia was started by the Capital Group. Capital Group manages American mutual funds. According to Reinhardt Krause, "Capital wanted in on the venture capital business. With its help, Valentine in 1972 started Capital Management, a forerunner of Sequoia."[29]

Grom Venture Capitalists

1. Trae Vassallo (1973-). Trae Vassallo is a venture capitalist with Kleiner Perkins Caufield & Byers. Her main areas of interest are green technology and consumer Internet services. She has helped back a variety of companies in these fields, such as Altarock Energy and Aggregate Knowledge. Before joining Kleiner Perkins, she "learned to program when she was 7 and at 28 cofounded a wireless e-mail company that Motorola bought for $550 million."[30]

2. Sky Dayton (1971-). Sky Dayton founded EarthLink, cofounded eCompanies, and is the founder and current chairman of Boingo. Early in his career as an entrepreneur, Dayton owned a pair of trendy Los Angeles coffeehouses. In 1994, he started EarthLink. EarthLink became a huge player in voiceover Internet protocol (VoIP), which allows users to make telephone calls across the Web. Dayton originally got his funding through angel investors:

> In 1994 I got the idea for EarthLink and scraped together $100,000 from a couple of angel investors. The commercial Internet was just beginning, I hadn't heard the words *venture* and *capital* in the same sentence, and I actually believed that $100,000 was a *ton* of money. Today EarthLink has a billion-dollar market cap, $600 million in the bank, nearly 5 million customers, and 6,500 employees.[31]

EarthLink went public on January 22, 1997, selling 2 million shares to raise $26 million. eCompanies began as a way to start and develop Internet companies. Privately held, it struggled for several years until it successfully launched companies like LowerMyBills.com.

3. Samir Kaul (1974-). Samir Kaul is a founding general partner at Khosla

Ventures and "the right-hand man of Vinod Khosla."[32] He focuses primarily on clean technology and life sciences companies. He has backed companies such as Austra and Great Point Energy. Furthermore, "Samir Kaul led the effort to effort to sequence the genome of the Arabidopsis plant and then built three life sciences companies from scratch."[33]

4. Elon Musk (1971-). Musk was a cofounder of PayPal, an online payment service launched in 2002. He sold PayPal to eBay for $1.5 billion. Musk is now chief executive of Space Exploration Technologies, a company he founded with $100 million of his own cash. Musk is now working with solar power company SolarCity, which makes solar products. Musk is also well known for his involvement in Tesla motors, makers of the high-performance electric sports car, the Tesla Roadster. Musk is also well known for his pet project, SpaceX, a company that makes space-launch vehicles. It is Musk's ultimate goal to put a greenhouse on Mars.[34]

5. William "Bo" Peabody (1970-). Along the way, one of the entrepreneurs I became very acquainted with regarding venture capital was Bo Peabody. I met Bo in the late 1990s. We both like to invest in venture capital. Our learning experience revolved around venture capital, and the trials and tribulations we experienced were not too different from those in college or graduate school. Before becoming a venture capitalist, Bo founded a company named Tripod in 1992, which was bought by Terra Lycos. Basically, Tripod gave individuals the ability to publish their own "personal homepages." In the mid-1990s, NEA invested $3 million into the company. A couple of years later, Bo was made an offer he could not refuse. As Bo summarized in *Lucky or Smart? Secrets to an Entrepreneurial Life:* "On December 31, 1997, I agreed to sell Tripod in exchange for $58 million in stock of a publicly traded company named Lycos, which at the time was an internet company only slightly more stable than Tripod."[35] Bo now runs Village Ventures which is based in Williamstown, Massachusetts. According to Bo, in an interview with the author, "Village Ventures is a venture capital firm specializing in seed and early stage investments. The firm typically invests in consumer media and retail, health care, and financial services companies based in the United States. For early-stage investments, it invests in companies with revenues less than $10 million and within seed investments, the firm invests in companies with no revenues."

6. Peter Thiel (1967-). Thiel provided funding to PayPal in 1998. In October 1999, PayPal was launched, an online person-to-person payment provider. PayPal was backed by Sequoia Capital, Nokia Venture Partners, and Clearstone Venture Partners (formerly Idealab Capital). Thiel was the chief executive officer and helped PayPal go public:

> That March, as the NASDAQ Composite Index roared its way to a record 5048, Thiel set out to raise money from venture capital investors. Dot-com fever was running high, and VCs valued the money-losing PayPal at $500 million. "Everyone thought that wasn't high enough," Sacks says. Everyone except Thiel. He looked at the NASDAQ frenzy and concluded the dot-com bubble was about to pop. He seized the opportunity. Based on the $500 million valuation, Thiel raised $100 million, more than his colleagues had planned, and closed the deal in three weeks, on March 31, 2000. He was just in time. The next day, the NASDAQ began a plunge that would eventually send it tumbling 67 percent in 18 months. "If he hadn't made that call, the company wouldn't be around today," Howery says of Thiel.[36]

After selling PayPal to eBay for $1.5 billion, Thiel founded Clarium Capital Management, LLC, a combination hedge and venture fund based in San Francisco.[37] Thiel is a wave rider.

Forbes 400 Members and Venture Capital

Quite a few of the wealthiest individuals in the United States have made fortunes from investing in companies and/or building them using venture capital. Figure 5.1 features a list of Forbes 400 members involved with alternatives (including venture capital).

The Formation of Venture Capital Waves

Although there were various forms of venture capital before this time frame, the venture capital industry truly solidified in the United States in the 1960s:

> Venture economics has data on the U.S. venture capital industry that

goes back to the late 1960s. By accessing that historical data and tracking new data as the industry evolved throughout the 1950s, we were able to analyze longitudinal data sets spanning 20 years. Over that period the industry went from being red-hot at the end of the 1960s to almost an ember by 1974; it rekindled in the late 1970s until it was white hot by 1983; then from 1987 it began to cool off.[38]

As data began being collected in the late 1960s and 1970s, it is evident there were venture capital waves even from the industry's infancy. Venture activity peaked in 1969 when the market reached a high and was followed by a 5-year bear market (see Figure 5.2).

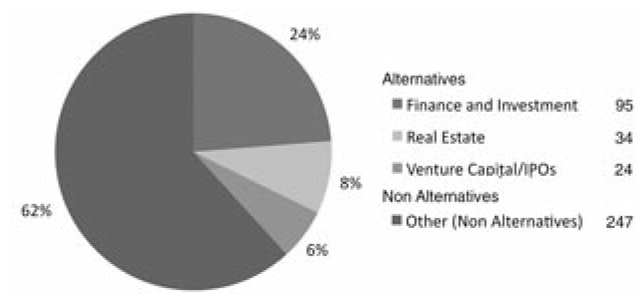

Figure 5.1 Forbes 400 Richest by Investment Type

Source: "The 400: 2009 Edition," *Forbes 400* (October 27, 2008). Used with permission.

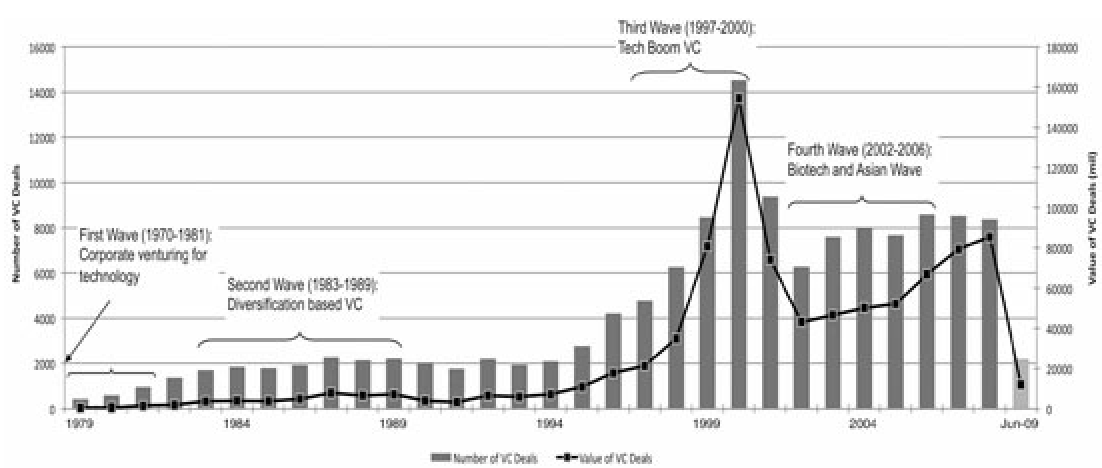

Figure 5.2 30 Years of Global Venture Capital Activity

Source: Author.

The first real wave of venture capital was started in 1970 and lasted until 1981 with corporate venturing for technology (shown in Figure 3.8). Venture capital did well in the 1970s after the capital gains tax was reduced. A standard legal form of venture capital funds evolved called the 10-year partnership. The 10-year partnership offered both a tax-friendly structure and enough longevity to attract institutional investors for longer-term commitments.[39] As a result of the 10-year partnership, pension funds and other institutional investors commenced buying venture capital.

It was really at this point that the modern concept of venture capital began. According to *BusinessWeek,* "The modern VC industry started in a partnership format in the 1970s and '80s."[40] As one can plainly see in Table 5.1, the idea of venture firms commenced in the 1960s and early 1970s.

Government Involvement

Over the years, venture capital has been at the mercy of government changes. Like all alternatives, investors must be cognizant of the investment climate at the time they are considering making an investment. Government actions can propel or chill investments in venture capital overnight, and the outcome can last over a decade. According to Scott Denne, "Increased regulations imposed on public companies, such as the Sarbanes-Oxley Act of 2002, have made going public a much less attractive option for venture-backed companies."[41] Figure 5.3 depicts a few of the major legislative changes that affected venture capital.

Here are some of the key moments of Figure 5.3 in detail:

1. 1958 Small Business Investment Company (SBIC) Act. Venture capital began with wealthy families, but changed after the Small Business Investment Company Act (SBIC) was created. The Small Business Administration (SBA) helped fuel venture investing by making attractive loans.

2. 1978 Revenue Act. The 1978 Revenue Act reduced the capital gains tax at the time from 49.5% to 28%. As a result, venture capital investing flourished.

3. 1979 ERISA ("Prudent Man") Rule. Government invention can be beneficial to venture capital as evidenced by the 1979 Employee Retirement Income Security Act (ERISA) Rule. The 1979 ERISA "Prudent Man" Rule

Table 5.1 History of Venture Firm Formation

1960s		1970s		1980s		1990s	
Name	Year	Name	Year	Name	Year	Name	Year
Sutter Hill Ventures	1964	Sequoia Capital	1971	Accel Partners	1983	Benchmark Capital	1995
Greylock Partners	1965	Kleiner Perkins	1972	Advent International	1984	Polaris Venture Partners	1996
Warburg Pincus	1966	NEA	1978	Edison Venture Fund	1986	Silver Lake	1999
TA Associates	1968			Sandler Capital	1988		
Venrock	1969			Hummer Winblad	1989		
Arthur Rock & Co.	1969						
The Mayfield Fund	1969						

Source: Author.

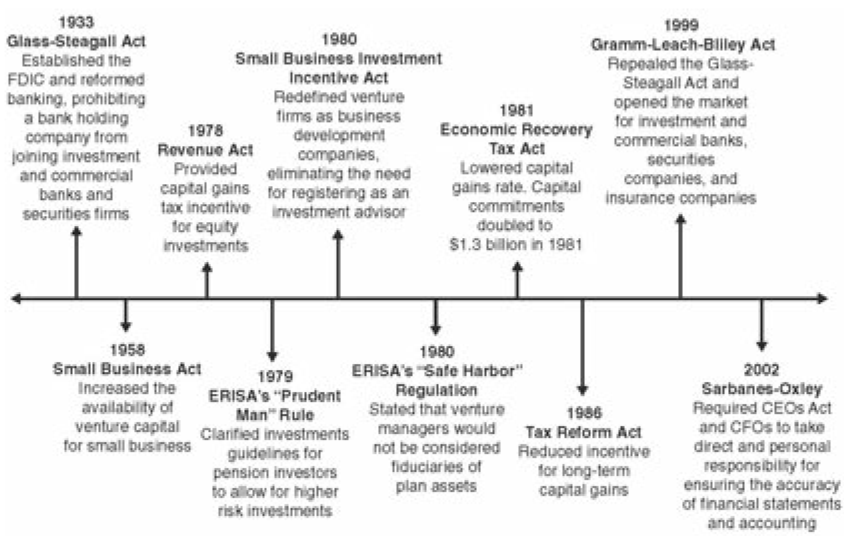

Figure 5.3 Legislative Impact on Venture Capital Investment

Source: Author.

governing investment guidelines for pension-fund managers was revised and clarified to allow for higher-risk investments, including venture capital arrangements.[42]

4. 1980 Small Business Investment Incentive Act. The SBII Act categorized venture capital firms as business development companies, which meant they need not register as investment advisors with the Securities and Exchange Commission (SEC).

5. 1980 ERISA "Safe Harbor" Regulation. The 1980 ERISA "safe harbor" regulation allowed venture capital firms to manage pension assets without becoming fiduciaries, which ultimately reduced their risk for accepting these new limited partners. People managing or investing funds do not like clients who are likely to sue them. Given this positive change, assets flowed into venture capital.

6. 2002 Sarbanes-Oxley Act. Government intervention can also be negative for venture capital as seen with Sarbanes-Oxley. The Sarbanes-Oxley Act of 2002 has had a dramatic effect on public companies. Sarbanes-Oxley, which became law on July 30, 2002, was the first comprehensive federal legislation to impose significant corporate governance requirements on public companies and to address the responsibilities of corporate executives and board members.[43] Chairmen, CEOs, board members, officers, auditors, legal council, and even banks have new regulation to contend with as a result of the act. New regulation was needed after events such as Tyco, Enron, and Worldcom, in which there was definitely too little regulation. However, Sarbanes-Oxley went far enough in the other direction to the point that it is now considered excessive. Both the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ) adopted new listing standards focused on heavy corporate governance.

Effect of Politics on Venture Capital

Surfers use the phrase "raked over," which means to be hammered by incoming waves while paddling out. Sarbanes-Oxley ("Sarbox") hammered a lot of CEOs as well as investors. A negative effect of Sarbanes-Oxley is dramatically higher accounting and legal costs for compliance. Going public, in other words, became extremely expensive for a small, fast-growing company. Some companies even need to raise venture capital for these added expenses. A general rule of thumb is a company should have approximately $10 million in the bank before pursuing an IPO today. Murray Beach, managing director of TM Capital, describes the venture capital market in the aftermath of Sarbanes-Oxley:

> Where the IPO was the favored choice for entrepreneurs and their investors when raising growth capital in the 80's and 90's, most managers and boards of successful young privately held companies today are opting to stay private and raise money from venture and private equity funds or have decided to enter the M&A market and sell their business to larger companies. The cost, burden, and risk of being a public company is now too high. Investors are not interested in the risks associated with stock in a small public company, and the professionals and institutions which have the expertise in creating public companies have abandoned this part of the market and moved to other segments.[44]

Ironically, the U.S. government did a 180-degree turn with venture capital. Precisely one decade before Sarbanes-Oxley, the SEC helped companies prosper. The SEC adopted rules in August 1992 intended to make it less costly and burdensome for small- to medium-sized growth businesses to raise capital. Government intervention often is extreme. One minute a company has loosey-goosey regulations (1992), and the next minute they are as tight as a steel drum (2002). Somewhere there is a happy medium. The approach of letting growth companies have a free-for-all and then strangling them with red tape does not seem rational. While politicians debate back and forth, investors can take advantage of these extreme waves in the meantime. Pay particular attention as to when and where you are considering investing in venture capital.

Government actions can also affect exit strategies for venture capital. Each government is different regarding how they view small businesses. For instance, the SBA assists entrepreneurs with 500 or fewer employees. A business must be a certain size to qualify for federal grants or be given government contracts. The SBA Web site has a classification system and defines which businesses are considered small businesses. Historically, there have been certain times the U.S. government is favorably inclined toward small businesses and other times it is not. In 2009, the National Venture Capital Association was quoted in response to the economic melt-down of the late 2000s: "This is a time the country should be supporting venture capital firms because we're in the business of creating new companies and new jobs, which is what the country needs right now."[45]

Initial Public Offerings

The governments of Israel, Singapore, and China value venture capital. These nations have made huge strides toward creating environments that are favorable toward venture capital. What is the tax structure for venture-backed companies? How does the IPO market look? What kind of exchanges exist for publicly traded companies? What does the M&A market look like? Delbert Smith, senior partner at the global powerhouse law firm Jones Day, advises, "Companies looking to go public or merge, need to examine venture waves as well as trends in the IPO or M&A market places."[46] IPOs are a primary exit for venture capital. According to Wright and Robbie, authors of *Management Buy-Outs and Venture Capital,* "Historically, IPOs have been the preferred means to exit venture capital. The most important determinant, by far, of the health of the venture capital industry is the condition of the IPO market. All other factors pale in comparison."[47] *Investor's Business Daily* says, "A strong IPO market is key to venture capital investors, who depend on the public markets to cash out of their investments."[48] Without a robust IPO market, the exit strategyfor a venture capital firm is reduced to just M&A (the other central exit strategy). According to George M. Taber, "An initial public stock offering has long been the epitome of success for a startup company. It's also the ultimate liquidity event because the company stock is freely traded on one of the stock exchanges."[49] When a company is public and the lockup expires, venture capital investors can sell at their leisure; the shares are freely tradeable.

Figure 5.4 uses a chart to show 30 years of U.S. initial public offering activity.

Venture capital moves in waves, and so does its main exit strategy, the IPO. When the IPO market is robust, venture capital funds can exit quickly and make a profit. According to Wright and Robbie, "Successful timing of a venture-backed IPO provides significant benefits to venture capitalists in that taking companies public when equity values are high minimizes the dilution of the venture investor's ownership stake."[50] Any seasoned venture capital expert will be cognizant of venture capital and IPO waves. Years ago, I met Ed Mathias, who runs the venture arm of the Carlyle Group, and I remember his advice on venture capital from his decades of observations. He best describes the cyclical nature of venture capital and the IPO market this way:

Venture capital again peaked in terms of fund-raising in 1987 following the bull market and ensuing IPO boom. Performance is historically followed, with a delay, by money into venture capital. Coincident with the '87 market peak, the venture industry raised $4 billion. For perspective, and as further testimony to the historic cyclicality, fund-raising declined to $1 billion in 1991 as performance of the mid-'80s funds lagged. There was virtually no IPO market, with the cumulative amount of IPOs from 1988 to 1990 being less than was done in 1986 alone. I believe after the crash in 1987, there was only one deal done for the balance of the year.[51]

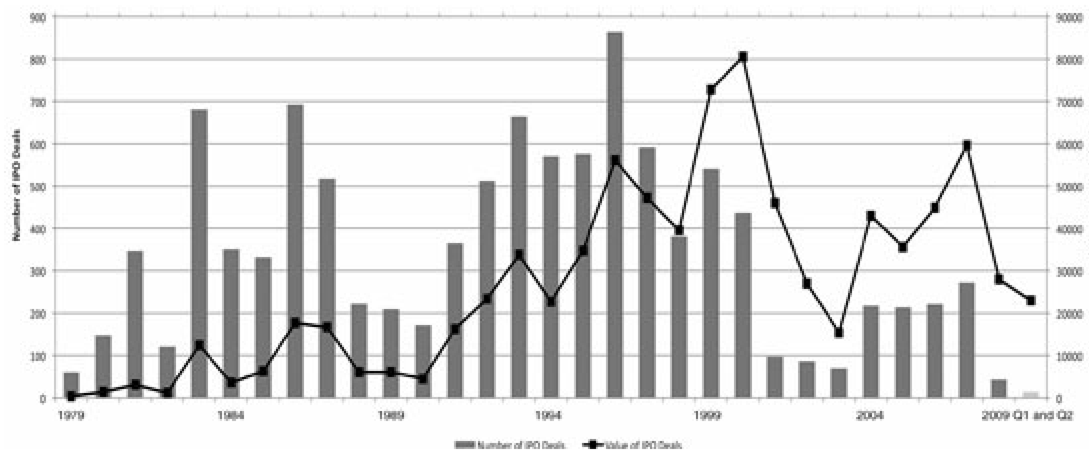

Figure 5.4 30 Years of U.S. Initial Public Offering Activity

These cycles, patterns, or trends occur on a regular basis. Table 5.2 shows a number of banner as well as lackluster IPO years.

Waves can be identified in shorter periods with venture capital. There are years when venture capital is perfect to surf with a robust market and plenty of IPOs (1968-368, 1969-780, 1970-358, 1971-391, 1972-562, 1973-105). Venture capital firms are adept at taking portfolio companies public at peak periods. According to Wright and Robbie, "Seasoned venture capitalists appear to be particularly good at taking companies public near market peaks, though of course this does not necessarily mean that such timing is appropriate from the point of view of the company itself."[52] When an investor sees a lot of venture-backed IPOs in a certain area all going public, it usually means the potential for upside investing in a private company in this area is limited because the ride is almost over or ending shortly. By the time the company is ready to go public (unless it is really different or superior to all the other competitors in the area in which it filed to go public), investors can lose a lot of principal.

Other times, you want to put your surfboard away when the IPO market slows to a crawl (1974-9, 1995-12, 1976-26, 1977-15, 1978-20, 1979-39, 1980-75). If one was observant, one might note the last 3 years were steadily rising (from 1978-20, 1979-39, and 1980-75). Based on this trend, would 1981 be a good year for venture capital? Probably. In fact, 1981 provided 197 IPOs, indicating that the IPO market was very much improving. Waves keep on moving. They will never end. Bygrave and Timmons state,

Table 5.2

Year	Number of IPOs
1961	435
1966	85
1969	780
1974	9
1983	521
1990	112
1996	687
2003	68
2004	186
2008	21

Source: Author.

Source: Author.

"Historically, the ability to harvest an investment depended heavily on a hot new issues market."[53] In 1983, there were a huge number of IPOs, totaling 521 new issues (see Table 5.2). Until 1986, the IPO market was robust. But all good things must come to an end. On October 19, 1987, the stock market crashed, and IPOs dwindled again.

During my career, I helped place funds for at least 1,000 private companies and IPOs. Certain top-quality IPOs can do well in bad markets. It is not unreasonable, therefore, for select private companies to do the same—there are always good buys. Rosetta Stone is a good example of a private company going public in a terrible market. Rosetta Stone was priced at $18.00 on April

16, 2009, and reached a high of $32.97 soon after. The years 2000, 2001, and 2002 were negative years for the equity market. As evidenced time after time, venture capital trails public equities. The year 2003 was terrible for IPOs. However, venture-backed IPOs did well in 2003. Venture capital investing picked up in 2004 in terms of amount invested and number of deals (compared with 2003).

Venture capital trailing the IPO market is nothing new, as evidenced by Ernst & Young's report, "3Q'09 Venture Insights,"[54] which claims there were 6,351 deals with a record amount invested in venture capital for 2000. Figure 5.5 illustrates this wave:

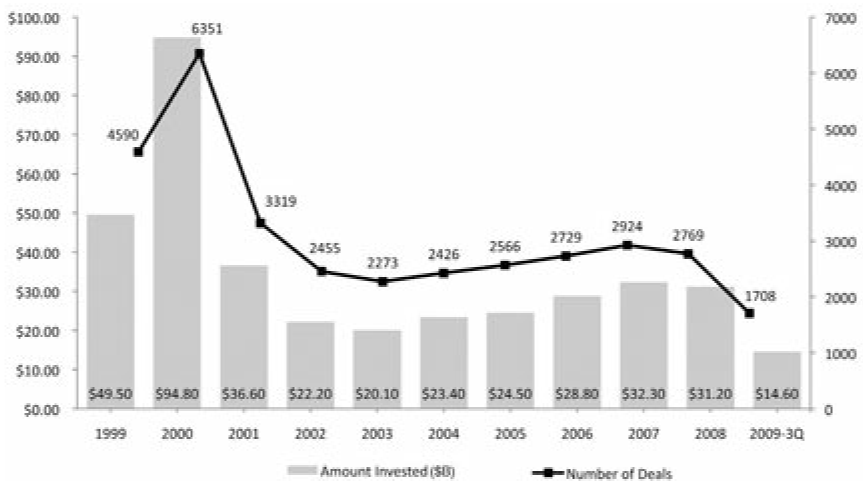

Figure 5.5 Annual Deal Flow and Equity into Venture-Backed Companies

Source: Ernst & Young, "3Q'09 Venture Insights," 2009. Used with permission.

The year 2000 was when the tech bubble burst. Yet it was a record year for venture capital. Incidentally, Figure 5.5 also shows waves of both number of deals and amount invested for venture capital. These waves move in sync. Following the IPO market, venture capital started doing well after 2003. A total of 85 companies came to market in 2003 raising $15.77 billion, followed by 249 U.S. IPOs in 2004 raising $48.12 billion, versus 385 companies raising $60.63 billion in 2000.[55] As evidenced in the past, venture capital followed the IPO market with increased number of deals and amount invested until the 2007 recession. IPOs can be quite lucrative, as seen in Table 5.3, which details various IPOs released in 2005 and 2006.

The years 2005 and 2006 were good years to go public. Because the IPO market is a way for an investor or fund to exit their investment in a private company, one needs to be cognizant of where one is with

Table 5.3 Initial Public Offerings

Company	Ticker	Issue Price	Date of IPO	High	% Gain	High
Lazard Ltd	LAZ	$25.00	05/04/05	$55.75	123%	05/02/07
XenoPort	XNPT	$10.50	06/02/05	$65.86	527%	01/18/08
Focus Media Holding	FMCN	$17.00	07/13/05	$65.10	283%	11/06/07
Adams Respiratory	ARXT	$17.00	07/20/05	$60.01	253%	01/24/08
Genco Shipping	GNK	$21.00	07/21/05	$84.00	300%	05/16/08
CF Industries	CF	$16.00	08/10/05	$169.62	960%	06/17/08
WebMD Health Corp	WBMD	$17.50	09/28/05	$61.35	251%	10/10/07
Intercontinental Exchange	ICE	$26.00	11/15/05	$194.50	648%	12/26/07
SunTech Power	STP	$15.00	12/13/05	$88.35	489%	12/26/07
Altus Pharmaceuticals	ALTU	$15.00	01/25/06	$25.25	68%	03/17/06
Chipotle Mexican Grill	CMG	$22.00	01/25/06	$152.36	593%	12/26/07
NightHawk Radiology	NHWK	$16.00	02/08/06	$26.99	69%	12/20/06
Alexza Pharma	ALXA	$8.00	03/08/06	$15.21	90%	03/26/07
CTC Media	CTCM	$14.00	05/31/06	$31.75	127%	02/27/08
Omniture Inc.	OMTR	$6.50	06/27/06	$36.81	466%	10/30/07
WNS Global Services	WNS	$20.00	07/25/06	$35.43	77%	02/08/07
InnerWorkings Inc.	INWK	$9.00	08/15/06	$18.69	108%	10/09/07
Ehealth	EHTH	$14.00	10/12/06	$35.99	157%	11/16/07
Hansen Medical Inc.	HNSN	$12.00	11/15/06	$38.87	224%	10/31/07
First Solar Inc.	FSLR	$20.00	11/16/06	$311.14	1455%	05/16/08
Spirit Aerosystems	SPR	$26.00	11/27/06	$40.50	56%	07/19/07
Affymax	AFFY	$25.00	12/14/06	$40.87	65%	02/12/07

Source: Author.

regards to IPO waves. When the broad market tanks, IPOs dry up and venture capital follows. Buying IPOs during an overheated market or top of the market might be as reckless as throwing money into venture capital during the same period. IPOs will likely plunge as hard if not more than the broad-based market, and private valuations might implode. Private companies need a lot of fuel, which is difficult to get in bear markets. In fact, many private companies go bankrupt in difficult times because they cannot get financing. Low valuations for private companies as well as increased costs for going public due to Sarbanes-Oxley, weaken the entire venture capital market. In Figure 5.6, one can see the number of venture capital deals from 1994 skyrocket to 2000.

The year 2000 shows IPOs falling off a cliff while the number of venture capital deals reached an all-time high. The reason for this is that public markets (including IPOs) move very fast, unlike venture capital, which is private. Deals that were restricted or cash committed to venture-backed companies take a while to register. Likewise, when the market finally picks back up, as depicted by the line representing the number of IPO deals from 2003-2004, venture capital will follow, as seen by the bar charts from 2003-2004 as investors start putting money back into venture capital.

The venture capital wave charts combined with IPO waves can be very helpful in decision making when an investor contemplates when to exit an investment in a private company. In some cases, if you invested in a private company (and it filed for an IPO), it makes sense to exit your investment when the company goes public. Other times, one might hold the IPO shares (if the IPO market appears to be doing well). In one case, I held my shares after an IPO and the stock did extremely well. I realized a much better return on my investment. Both the IPO market as well as the general market were in an uptrend. Further, the company continued to have positive news and improved finan-cials. Letting winners run can be beneficial. One can also have an attractive company but the venture capital and IPO waves look ominous. In other scenarios, I sold some shares on the IPO and kept some shares in order to hedge my bet. The stock proceeded to crater. My error

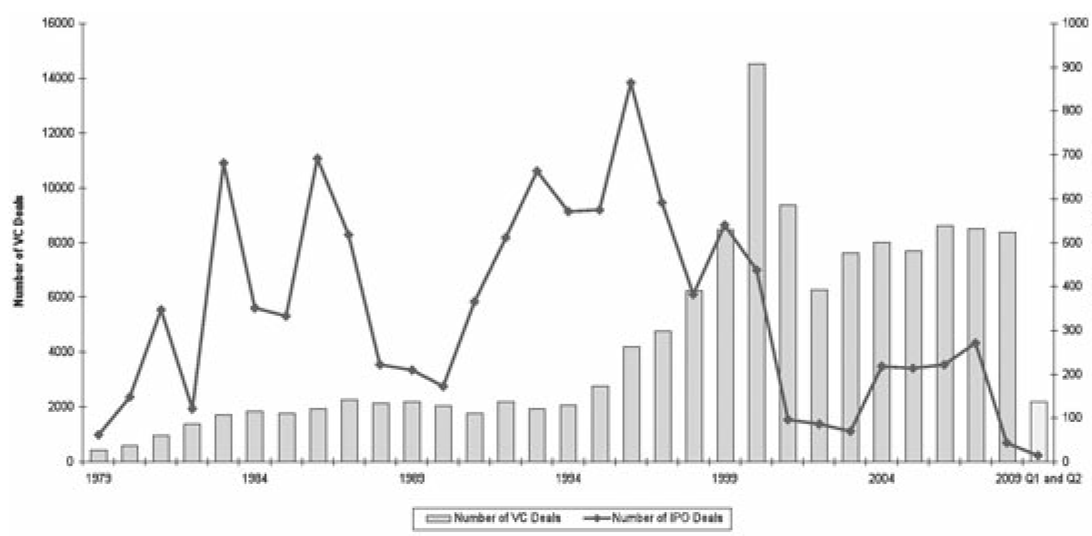

Figure 5.6 30 Years of Global Venture Capital versus U.S. Initial Public Offering Activity

Source: Author.

was that I should have sold all the shares at the offering because the handwriting was on the wall with the direction the waves were heading. My warm relationship with the CEO clouded my judgment and I forgot an important rule: Never fall in love with an investment. Invest to make money, not friends.

Mergers and Acquisitions

Besides IPOs, the other main exit for venture capital is mergers and acquisitions. Before the tech bubble bursting, it was not out of the ordinary for venture-backed companies to go public in 2 to 3 years. After Sarbanes-Oxley, the exit horizon greatly expanded to 7 to 10 years. While the IPO market was slammed, M&A activity continued to prosper. According to the *Boston Business Journal,* "The number of initial public offerings by venture-backed companies has decreased so far this year compared with the same period last year. Prevailing conditions in the stock market and a healthy acquisitions market have made public offerings a less tempting exit strategy for venture capitalists."[56] In Figure 5.7, one can see the number of M&A deals (the bars) has steadily increased from 2001 until 2008. Because the exit for venture capital saw one of its primary exit strategies (IPOs) vanish, M&A became much more popular. Richard A. Silfen, M&A attorney and senior partner at Duane Morris, LLP, states, "the M&A wave picked up since the IPO market declined. Timing is everything in M&A."[57] M&A waves are affected by a number of variables, which are evident by the value of M&A deals (the line) as shown from 1995 to 2000.

Figure 5.8 shows that although the size of deals might have decreased, M&A activity remains high, especially with venture capital. The *Wall Street Journal* noted 404 acquisitions of venture-backed companies ($31 billion in value) in 2006, with similar figures for 2005 (401 acquisitions at $30 billion).[58] One can also see from the chart (looking at 2000-2002) that as venture capital deals slow, M&A deals do as well. Valuation becomes more of an issue between buyer and seller because of public comparables.

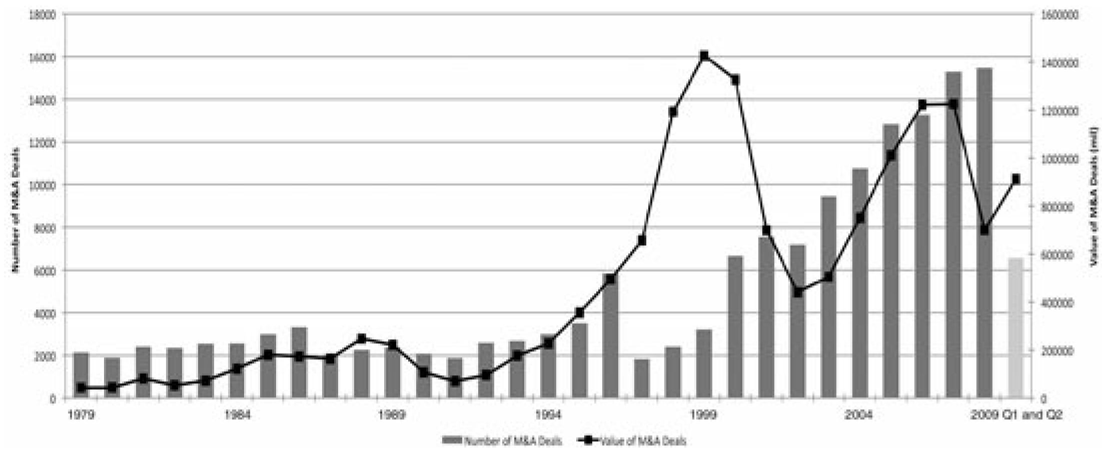

Figure 5.7 30 Years of Global Mergers and Acquisitions Activity

Source: Author.

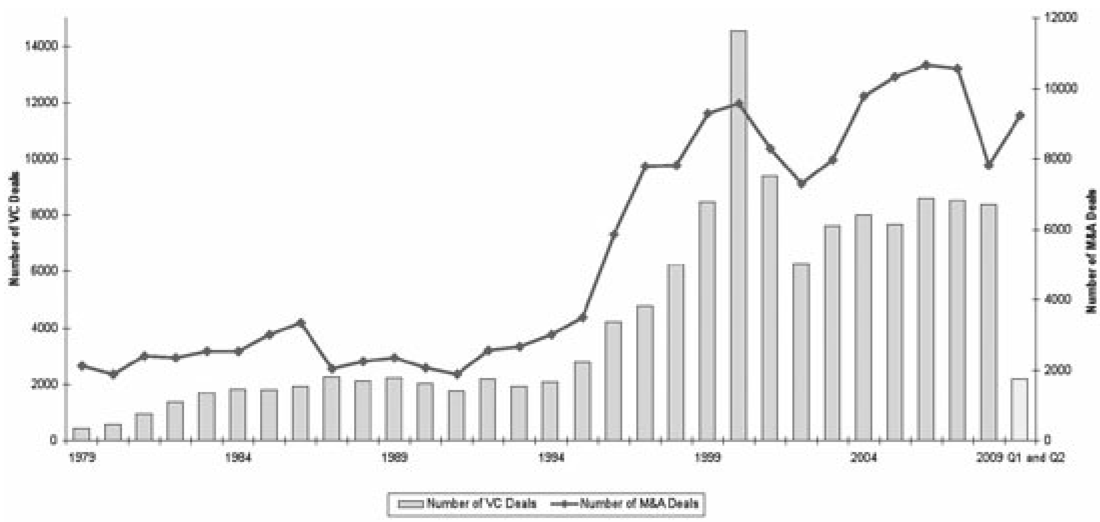

Figure 5.8 30 Years of Global Mergers and Acquisitions Activity

Source: Author.