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U.S. MARKET COMMENT: AFTERMATH OF THE VENTURE CAPITAL BUBBLE

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Aftermath of the Venture Capital Bubble: Weighing Investor Concerns

As the popularity of venture capital (VC) investing soared in the late 1990s, general partners (GPs) increased their fund sizes significantly and collected enormous management fees. In 2000, more than 50 VCs had at least $1 billion under management, which translates to $250 million in management fees assuming a 2.5% rate over a ten-year fund lifetime. Amid this euphoria, limited partners (LPs) aggressively competed for access to the top-performing VC firms in 1998, 1999, and early 2000, only too willing to pay management fees of 2.5% and premium carried interest of 25% or even 30%, in expectation of extraordinarily high returns. Investors poured capital into VC funds at unprecedented rates, investing over $153 billion in 1999-2000—more than the cumulative total of all prior commitments since 1946. As returns have plummeted, the attitude of many LPs has changed dramatically.

Basis for LP Discontent—Legitimate Concerns?[1]

Capital Overhang

LPs are concerned about the huge amount of capital that has flowed into venture funds, but has not yet been invested, the so-called "capital overhang" of approximately $41 billion, according to our own analysis (others' estimates range from $35 billion to $75 billion). This is a legitimate concern that raises many questions as to how VCs can achieve the same returns in billion-dollar funds that they achieved in million-dollar funds. If deal sizes remain similar, then firms will need to include many more deals. Will there be enough attractive deals? Will there be enough capacity among the partners to give those deals the time and attention they need to harvest value? If new partners are hired to handle the extra workload, will they fit in with the other partners and will they exercise reasonable judgment? Alternatively, if GPs choose to increase deal sizes, they may decide to abandon early-stage deals in preference of later-stage deals, which potentially would lower returns. Of course, many VCs are quick to point out that the capital overhang problem is overstated. They argue that with an extended investment cycle over the next several years, with adequate amounts held in reserve, and with no shortage of attractive deals in the pipeline, managers can prudently invest this capital as opportunities arise. This would enable VC firms to earn reasonable returns, but we would expect lower IRRs than experienced in the late-1990s, as performance during that period was extraordinary and should not be expected to repeat.

[1] This section highlights areas of primary concern today, excluding other issues, such as annex funds, cross-fund investing, clawbacks, and mismanagement, which are beyond the scope of this comment.

Management Fees

LPs are concerned about the hefty management fees VCs are collecting on committed capital, much of which has not even been deployed, as the pace of investment has slowed significantly. The level of fees paid increased in recent years as fund sizes and frequency of fundraising increased. Furthermore, some firms are in a position to collect fees simultaneously from three or four funds. Will the fees—which are collected regardless of performance—undermine the incentive for GPs to continue to work hard for LPs, particularly among seasoned GPs who have already amassed large fortunes? Will the fees have a disproportionately negative impact on fund IRRs, given that the slowed pace of investments has significantly increased the gap between the commencement of paying fees and the receipt of distributions? For smaller funds, the 2.5% does not seem exorbitant, as management fees are intended to make sure that managers can cover operating costs and be in a position to exercise discipline in good times and bad. At the other extreme, LPs should be concerned about prospective returns from managers who have doubled their fund sizes—and their fees—in recent years without commensurately increasing their operating costs. However, the situation varies among managers, as some already have budget-based fees, and others have increased operating expenses along with fund sizes as they hired more staff to effectively manage the extra capacity.

Interim Valuations

LPs rely on managers to provide reasonable interim valuations, as these valuations impact a variety of important measures and planning tools including performance statistics, endowment spending calculations, and budget projections. At present, LPs are concerned about what they perceive to be unreliable, inconsistent, and misleading interim valuations of underlying portfolio companies. They are particularly troubled when they find that co-investors in the same companies may have very different valuation methodologies for when to write-up, write-down, and write-off an investment. We believe that, for the most part, VCs subscribe to a similar set of valuation methodologies. Using our database of audited quarterly and annual financial statements of almost 900 venture funds and over 25,000 (not all VC) portfolio companies, we cross-checked investments held by several managers and did not find any "significant" disparities in the reported valuations from fund to fund. In fact, a recent survey by Deloitte Touche of 150 VCs reveals remarkable similarities in their approach to decreasing (or increasing) the carrying value of portfolio companies, under a wide variety of scenarios. It is likely that LP concern over interim valuations is largely based on differences in the timing of valuation adjustments across managers.

Response of VCs

Despite the barrage of recent articles in the media about the alleged shifting balance of power from VCs to LPs, to date there has been limited evidence of a major sea change. The response of VCs has varied and generally has been a function of the terms, expected investment pace, need for follow-on capital, and concerns, if any, voiced by LPs. There have been a number of important actions taken by some VCs, specifically, reduced fund sizes and management fees.

Without violating the confidentiality of manager or investor communications, the following are examples of changes that have been reported in the public domain, specifically in the *Economist*, April 11, 2002; *Private Equity Week*, March 25, 2002; *San Jose Mercury News*, March 12, 2002; and *The Wall Street Journal*, April 1, 2002.

- Two firms have reduced the size of their most recent funds, one by 20% and the other by 25%, while a third firm is reducing the size of its most recent billion-dollar fund, but has not decided exactly by how much.
- One firm has reduced fees by one quarter and has informed LPs that it may not call down 20% to 25% of its current fund.
- Another firm has reduced the fee on its latest fund from 2.5% to 2%.
- One firm has offered a proposal to LPs to split its billion-dollar fund in half, not investing the second half until late 2003 or 2004, thus foregoing fees on that amount until later.

In addition, we are aware that many other VCs are seriously considering similar remedies.

Implications for the Asset Class

A deal is a deal. Once an agreement with a VC has been negotiated, LPs have little, if any, recourse to change the terms and conditions. LPs have a limited number of options including: (1) walk away and pay a big penalty; (2) sue and try to win damages (unlikely); (3) sell on the secondary market (limited number of buyers and potentially onerous discounts); and (4) vote in favor of a "no fault divorce" if included in the agreement (rarely invoked). In addition, LPs choosing to exit a partnership put their access to future funds at risk, particularly among top-quality managers. However, managers would also be wise to recognize that if equity markets were to enter into a prolonged slump during which VC funds experienced subpar returns, the flow of capital to VC would likely slow significantly. Just as VC fund terms and conditions became increasingly favorable to GPs in the strong bull market of the last decade, any persistent downturn in performance would open the door for LPs to negotiate more favorable terms for future funds.

The fact that some VCs are willing to take action suggests that LPs should continue to voice any significant concerns. Surely some of the larger and more sophisticated LPs are in a position to wield influence, especially if they decide to collaborate on certain issues. Historically we have not seen evidence of such collaboration, but that may change. For example, there seems to be momentum gathering from the newly established Institutional Limited Partners Association (ILPA), led by Rick Hayes of CalPERs, the largest public pension fund in the world. The ILPA now represents over 300 members and has been leading a high-visibility public campaign in demanding greater transparency and other changes in the VC industry.

Further Research

LP concerns about the increased size of funds, higher management fees, and interim valuation methodologies highlight the need for further research addressing important questions, such as: What is the optimal fund size for early-stage venture investing? Should management fees be budget-based? Should the industry adopt standardized valuation methodologies? Is the secondary market becoming more liquid? Is the market becoming more efficient? While we continue to investigate these questions, we also recognize that the underlying foundations of venture capital—innovation and committed and capable entrepreneurs—are still in plentiful supply and are growing. Investors should keep in mind that downturns are part of the nature of this asset class, and this one comes on the heels of an unprecedented upswing.