Optimism for the VC Market — 2004 Review & 2005 Outlook

an excerpt from Wilmer Cutler Pickering Hale and Dorr LLP's VC Report

The U.S. venture capital financing market — measured by both financing activity and liquidity events — was hardly robust in 2004, especially as compared to the aberrant market conditions of 1999–2000. However, by most measures, the market was noticeably stronger than in 2002 and 2003, fueling optimism that we may see continued improvement.

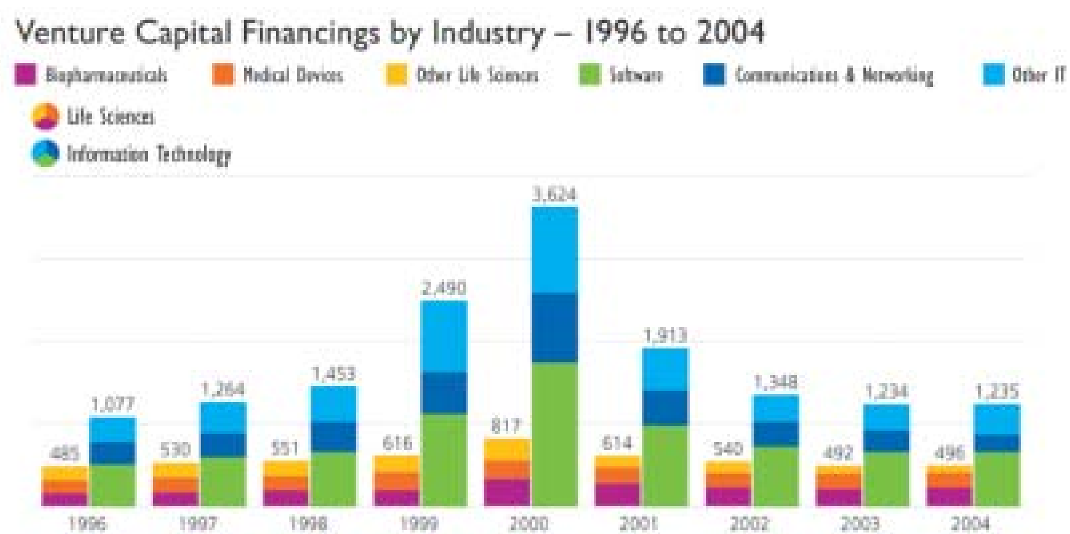
The number of venture capital financings in 2004 (2,067) was essentially the same as in 2003 (2,092). The total amount invested in venture capital financings increased from \$18.9 billion in 2003 to \$20.4 billion in 2004, reversing a three-year decline. However, the number of financings and the amount invested remain well below the levels reached during the 1999–2001 Internet bubble (\$94.6 billion was invested in 2000), and the number of financings also remains below the levels of 1997–1998 and 2001–2002.

The average size of venture capital financings grew from \$9 million in 2003 to \$9.9 million in 2004. This increase also reverses a three-year decline, and represents the highest average financing amount for any year other than the 1999–2001 period. The average financing size was significantly higher in the life sciences industry (\$13.3 million) than in the information technology industry (\$9.2 million), although both industries had comparable increases over 2003. The average financing size in the life sciences industry is the largest on record, as the outlandish statistics from 1999–2001 were primarily a phenomenon of the IT sector.

Valuations of venture-backed companies showed a significant uptick in 2004. The median pre-money valuation for venture financings increased from \$10.8 million in 2002 and \$10 million in 2003 to \$13 million in 2004, reflecting the improved market for liquidity events (discussed below). Despite this increase, however, 2004 valuations were still well below the median pre-money valuations in 1999–2000. For the fourth consecutive year, the median pre-money valuation of life sciences companies (\$16.3 million in 2004) exceeded that of information technology companies (\$12 million in 2004).

Seed and first-round venture capital financings as a percentage of total venture capital financings increased slightly from 30% in 2003 to 33% in 2004. This percentage remains well below those of 1996–2000, when seed and first-round financings represented between 48% and 55% of total venture financings in each year. This decline reflects venture capitalists' adoption of more rigorous investment criteria; their disproportionate expenditure of time on struggling portfolio companies; and the lengthening of the time it takes for companies to achieve liquidity, which keeps more later-stage companies in the pool of venture-backed companies receiving financing.

The breakdown of venture capital investments by industry sector has not changed significantly over the past several years. Financings of information technology companies as a percentage of total venture capital financings were between 54% and 60% in each year since 1996. Financings in the life sciences sector dipped to below 20% of all venture capital financings in 1999–2000, but have been between 23% and 24% of total financings in each of the last three years. The dollar amount invested in life sciences companies as a percentage of all venture investments (31% in 2003 and 32% in 2004) is higher than the percentage of life sciences financings (24% in both 2003 and 2004), reflecting the greater financing needs of life sciences companies.



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The geographic locations of venture-backed companies have changed very little in the past 10 years. California-based companies accounted for 42% of all venture financings in 2004, and have led the country in this regard in each year since 1996. Massachusetts was home to the second largest number of companies receiving venture financing in each year since 1996, accounting for 12% of financings in 2004. Texas, New York and Washington rounded out the top five states for venture capital financings in 2004.

There was significant improvement in the IPO market in 2004 as compared to recent years. There were 67 IPOs by venture capital-backed companies in 2004, a figure that exceeds the total number of venture-backed IPOs in the three-year period from 2001 to 2003. This figure, however, not only remains lower than the IPO numbers during the 1999–2000 bubble, but is also lower than those from 1996 through 1998 (a surprising and often overlooked statistic is that there were more venture-backed IPOs in 1996 than 2000). In 2004, both the median amount raised in venture-backed IPOs ($50 million) and the median pre-money valuation of those companies ($224 million) were lower than in the 2001–2003 period. This is not surprising, as the IPO window was open for much of 2004, allowing more small companies to go public than in recent years. The median time from initial equity funding to an IPO was 5.7 years in 2004, which is equal to the 2003 figure and higher than that of any other year in at least 10 years.

The M&A market for venture-backed companies also improved in 2004. The number of acquisitions of venture-backed companies increased from 335 in 2003 to 376 in 2004. More important, the median acquisition price paid for venture-backed companies increased dramatically, from $18 million in 2002 and $23 million in 2003 to $40 million in 2004. While this figure is well below the median acquisition prices in 1999–2000 (including a staggering $100 million median in 2000), it is higher than the median acquisition prices in the 1997–1998 timeframe. The median time from initial funding to an acquisition was 4.7 years in 2004, the highest figure since 1996.

2005 Outlook

After four full years of a bleak venture capital market — particularly with respect to liquidity events — most industry observers are relatively cautious in their outlook for 2005. However, there are a number of reasons to believe that the market upswing that began in 2004 will continue, and perhaps gather momentum.

We believe that the number of venture capital financings, and the amount invested, is likely to increase in 2005 as compared to 2004. The increase in investment between 2003 and 2004 indicates some deal momentum as we enter 2005. In addition, the enormous amount of money raised and available for investment by venture capital funds should contribute to a higher level of investing activity.

We expect to see more bootstrapping by startup companies in 2005 than in prior years. Many entrepreneurs, believing that the valuation of their companies will increase (and thus the dilution to their stock holdings will decrease) if they defer venture financing until they have made significant progress in product development or customer validation, are funding their companies for the first six to 18 months from sources other than venture capital. These sources include angel financing, government grants and personal funds (often obtained through prior successes at venture-backed companies).

We also expect company valuations to increase in 2005. This view is supported by an extrapolation of recent trends, as 2004 valuations were up significantly over those of 2003. Under basic principles of supply and demand, the large amount of venture capital money available for investment should result in valuations — particularly those of "hot" companies — being bid up. In addition, the U.S. economy appears to be improving as we enter 2005. More important, there is some statistical evidence, as well as widespread anecdotal evidence, that corporate America is loosening its purse strings on technology spending for the first time in several years, a development that bodes well for many venture-backed technology companies.

The health of the venture capital industry is better measured by statistics on liquidity events than statistics on the level of investments. There are several countervailing factors that will influence the markets for IPOs and acquisitions of venture-backed companies in 2005, although we believe that the net result of these factors will be an improved market for liquidity events.

Factors that should positively affect the liquidity market include the expected improvement, noted above, in both the U.S. economy in general and corporate technology spending in particular. In addition, the significant increase in venture-backed IPOs in 2004 and the recent performance of the stock market bode well for IPOs in 2005. The M&A market was also much better during 2004, with the median acquisition price of $40 million representing the highest such figure since 2000. Moreover, if the U.S. dollar remains weak, venture-backed companies may attract significant interest from foreign acquirors.

One factor that continues to dampen the market for liquidity events is the Sarbanes-Oxley Act and the related regulatory environment facing public companies. Some venture-backed companies may be hesitant to go public because of the increased cost — including accounting and legal expenses and director and officer liability insurance premiums — and enhanced scrutiny that go along with being a public company. Similarly, concerns over the internal control environment and the need for personal certifications by CEOs and CFOs in SEC filings are causing many public companies to proceed cautiously, if at all, with respect to acquisitions of venture-backed companies. While these concerns are not likely to dissipate any time soon, there is hope that public companies will have more appetite, and more bandwidth, to pursue such acquisitions once their first internal control report and related auditor attestation have been completed and filed with the SEC (which, for many companies, occurred prior to March 15).

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