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Indicators point to a busy year for venture investors

Venture capital funds in the United States raised $17.6 billion in 2004, nearly double the amount raised in 2003. All indications are that 2005 will be an even bigger year, both in terms of the number of VC funds seeking financing and the total amount raised.

INSIDER VIEW

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At the same time, the venture capital industry is experiencing some interesting and significant trends, such as an increased focus on governance standards and the transformation of private equity into a more liquid asset class, all of which began in the post-bubble environment of the early 2000s and have gained broader acceptance since then.

The healthy pace of fund-raising activity is likely to continue in the coming year for a number of reasons. First, many venture capital firms delayed fund raising in 2004 in the hope that a more vibrant M&A and IPO marketplace would create liquidity events for existing funds. The hoped-for liquidity never materialized for many funds — but they are now running low on cash for new investments and are forced to enter the fund-raising market without significant distributions to investors from their funds raised most recently.

Second, emerging managers are entering the marketplace at a faster rate than existing venture capital firms are shutting their doors, increasing the total number of players in the market.

Third, many of the larger venture capital firms are expected to come to market in 2005. Although the larger firms intend to raise funds in the $400 million to $600 million range, significantly smaller than their most recent offerings, the median fund size of all venture capital funds raised in 2005 is expected to be higher than that of funds raised from 1999 to 2001. Less established venture capital firms will probably raise funds that are larger (in the $150 million to $250 million range) than their previous offerings.

With more money to deploy, competition among venture capital funds for portfolio company investments will increase. Increased competition and higher prices for portfolio investments will ultimately reduce the returns to investors that the industry as a whole will achieve.

And then there's regulation. The venture capital industry, like other segments of the alternative asset class, is attracting the attention of regulators and others who wish to impose stricter and more uniform governance standards. Industry-sponsored organizations are advocating increased uniformity in an industry that has historically been unregulated and independent.

The ongoing controversy over transparency and disclosure exemplifies this phenomenon. The transparency issue will likely remain in the news in 2005, as more and more previously undisclosed information about venture capital funds, their fees and their performance makes its way into the public domain. More demands will be made on venture capital funds to disclose information about their portfolio companies and deal terms, and litigation is likely to result as venture capital funds seek to protect that information.

Another example of this issue involves valuation of portfolio company investments. Many industry-sponsored organizations have recently adopted valuation standards and guidelines designed to harmonize the valuation metrics used for reporting purposes. These standards and guidelines are similar to those historically used in the industry, but there are important differences. Wide adoption of these newer standards in Europe is predicted, and it is likely that U.S. venture capital firms will feel increased pressure to adopt similar standards.

These debates may represent the beginning of a re-examination of the venture capital industry's traditional ways of doing business.

A robust secondary market in limited partnership interests has been established and a nascent secondary market in direct interests in portfolio companies has developed in the past few years. The significance of these developments may not become completely apparent for a number of years.

The secondary markets originally developed out of the need of distressed sellers to unload unwanted investments. These markets are now being viewed as asset-allocation or realignment tools, rather than as "last ditch" alternatives.

The growing secondary market in direct portfolio company investments provides venture fund managers with a new tool for trimming their portfolios. More venture funds are likely to take advantage of this market in 2005 as they deploy capital out of new funds and look for ways to lighten the burden of their older portfolios.

The venture capital industry continues to evolve in unexpected ways. This rapid evolution is likely to continue in 2005, with major developments revolving around the robust fund-raising market, governance and increasing liquidity.

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