Venture capital 2.0

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For the first time since 1978, there was no venture capital-backed IPO in the US during a quarter, making the second quarter of 2008 the worst on the EVCA records. This was attributed to the consequences of the liquidity crisis - but is this so? In October 2006, Steve Dow already launched a first statement which rippled through the venture capital sphere, by declaring that the venture capital model was 'broken'. Too much money chasing too few deals, not enough exits, no real perspectives of substantial profits on the short term: the diagnosis was severe, especially from this seasoned partner at Sevin Rosen. This was in fact the mark of a much needed revolution in the venture capital world, writes Cyril Demaria.

Creative destruction

The venture capital industry is under fire. A few funds are gathering most of the profits registered over the course of the last few years. Most of the funds are actually registering modest results, even inferior to stock exchange investmens. The reason is due to the fact that portfolio companies valuation has substantially increased, due to the impact of valuation methods.

It is core functioning of the venture capital sector which has to be reviewed. Between the first round of financing of a young company and its potential IPO, the holding period is 8.6 years in the US. Bearing in mind that venture capital partnerships are created for 10 years (maximum 12), it is necessary to review the organisation of financing of young companies.

The dogma according to which each investor should stay invested until the final sale or IPO of the company does not make any sense. This is hurting seed investors, as they are massively diluted by further rounds and it dries up this crucial part of the venture capital value chain by immobilizing the capital for no reason. Moreover, the value creation brought by initial investors, specialized in structuring and helping companies to emerge, is less obvious as the company grows and institutionalize.

The LBO as an example?

The increased size of venture capital funds give them dry powder to offer an acceptable exit parth for early investors wishing to opt out, paying them the risk taken and the value created. This is good for the venture capital industry, by forcing each participant of the value chain to focus on value creation and value each step forward ot the company - and assuming losses if the current investor could not bring the company to its next development stage.

Paradoxically, the example to follow for the venture capital industry could come from the leveraged buy out sector. The commoditization of this financial technique has incentivized some of the players to innovate and specialize. In this framework, have emerged sucessive buy-outs (secondaries, tertiaries, etc.). What appeared first as a parking situation for a future IPO or trade sale soon became a sustainable financing round, on its own right.

Each LBO corresponds to a specific target: structuring of a company, geographical development, diversification, concentration, mergers, acquisitions... Investments are structured in this framework and each of them is supported by an operational plan (the "first 100 days", for example). Venture capital investments appear as an exception, difficult to justify. It would however be more favourable and logical to size the capital injection to the need of companies, phasing it precisely.

The commoditization of venture capital: an opportunity

The semi-professionalization of business angels, and the subsequent specialisation of seed financing and venture capital to finance the creation, protyping, commercialisation and corporate development phases is from necessary. This fills a need as for the credit of SMEs and should also boost the development of venture lending - which has still to emerge as a counterparty to mezzanine finance for LBOs. Buying out existing early shareholders of a company should become the norm as well.

As venture capital has acquired a certain maturity, the risk being financed is better known and identified. This knowledge allows investors to refine their risk/return profile from their venture capital investments. It is thus logical to conclude that in the near future ventue capital will become an SME financing tool somehow casual, with a determined timeframe and with clear targets to reach. If high risk/high return financing will remain part of the venture capital industry, there will also be other forms of venture capital which will develop - the way LBO had over time, with the hope to avoid to replicate its errors.

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