

The Venture Capital Industry Analysis and Future Developments

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The following article is derived from an presentation that the authors prepared as an assignment for their MBA programme. The requirements for this assignment included an analysis of the industry structure, the markets and the players and the development of future scenarios.

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1 Overview

1.1 Definition

<p>Venture Capital is a subset of private equity, made for the launch, early development or expansion of a business.</p>

Private equity in the sense of Venture Capital provides equity capital to enterprises not quoted at the stock market. Private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to improve a companies gearing. It is also used to resolve ownership and management issues as the succession in family-owned companies or the buy-out or buy-in by experienced managers.

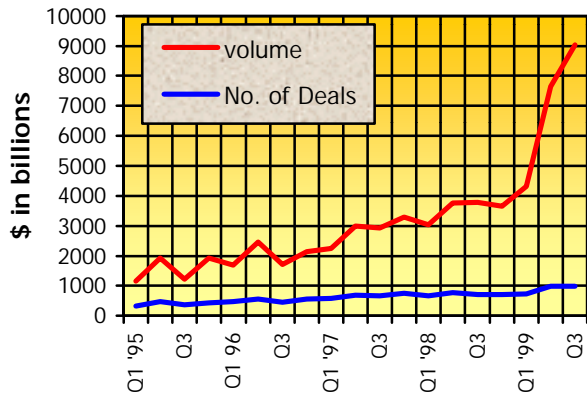
The key elements of Venture Capital are¹

- Investments in unquoted companies
- Is equity capital by nature
- Is medium to long-terms targeted at companies with growth potential
- Is combined with an active shareholder influence by the investor

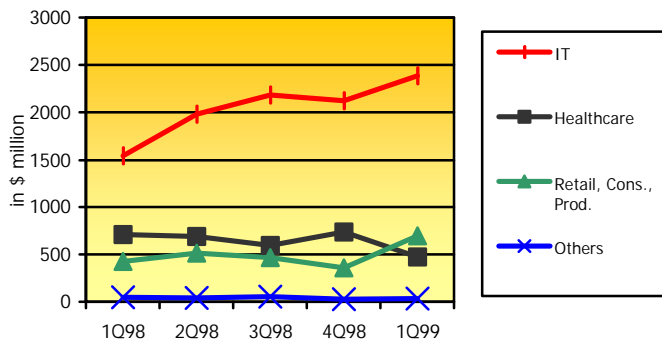
Among different countries, there are variations in what is meant by Venture Capital and private equity. In Europe, these terms are generally used interchangeably and Venture Capital thus includes the financing of management buy-outs and buy-ins (MBO/MBIs). This is in contrast to the US, where MBO/MBIs are not classified as Venture Capital. This paper adopts the European view.

The size of the industry rose considerably throughout the last years:

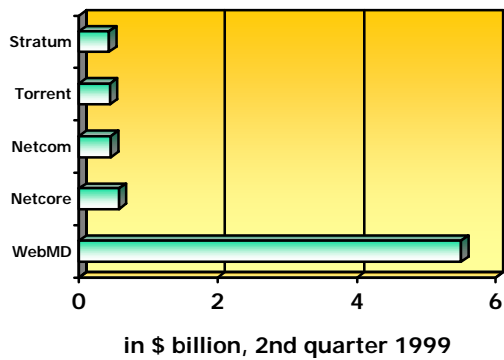
1 Englund, Claes: Dissertation: Development of the European Venture Capital market and Swedish Venture Capital companies' approaches for Risk analysis of Swedish closed companies



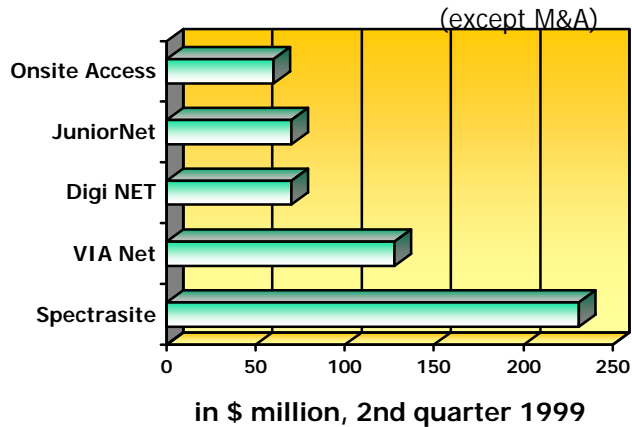
Whereas most sectors showed a relatively stable development, the growth was mainly based on Venture Capital investments in the IT-industry:



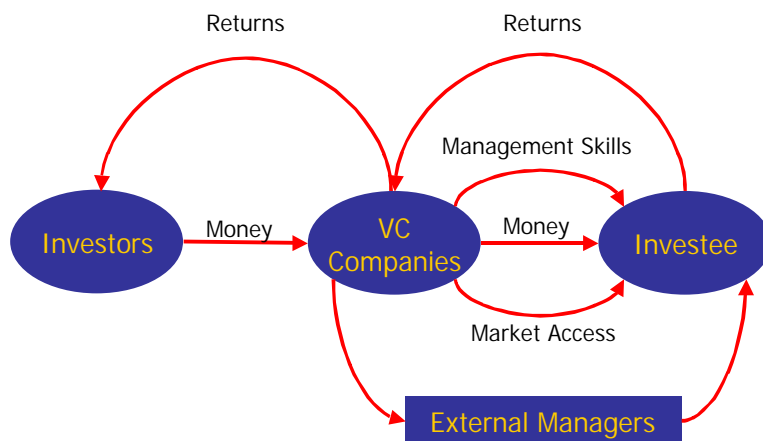
The five largest Venture Capital investments in the second quarter 1999 were



The above examples exclude Venture Capital financed mergers and acquisitions. The largest M&A's were in the same period



1.2 Involved Parties



The Venture Capital companies obtain their funds from investors. These are institutional investors, the parent companies of the Venture Capital companies, private individuals and other parties. Their money is comprised in a fund, which is managed by the Venture Capital company. The management decides to invest this money into investee-companies. In addition, the Venture Capital companies can provide their investees management skills, contacts and market access. If appropriate they find them external managers. VC companies are an active partner to the investee company e.g. by providing know-how and obtaining a network, in order to promote the companies growth and general business stability. This is reflected by representation in the board, act as management consultants and as financial advisors in certain projects.¹

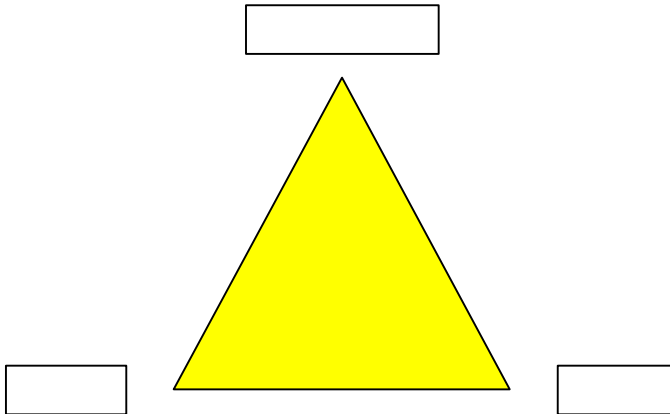
This management support is an important feature that differentiates Venture Capital from other sources of finance. The investees are often highly innovative companies in their growth phase that lack sufficient senior management skills.

The Venture Capital firms get their returns mainly when they sell out their stakes in the investee companies. Often this is done in the course of an IPO (Initial Public Offering).

1.3 Key success factors

¹ Englund, Claes: Dissertation: Development of the European Venture Capital market and Swedish Venture Capital companies' approaches for Risk analysis of Swedish closed companies

Venture Capital backed companies can provide high returns. However, despite of success stories like Apple, FedEx or Microsoft, a lot of these deals fail. It is said that only one out of ten companies succeed. That's why every deal has an element of potential profit and an element of risk, depending on the deals size. To be successful, a Venture Capital Company must manage the balance between these three factors.



Knowledge is key, to get the balance in this "Magic Triangle". With knowledge we mean knowledge about the financial markets and the industries to invest in, risk management skills and contacts to investors, possible investees and external expertise.

High profits, achievable by larger deals, are not only important for the financial performance of the Venture Capital company. As a good track record they are also a vital argument to attract funds which are the basis for larger deals. However, larger deals imply higher risks of losses. As we will show later, many Venture Capital companies try to share and limit their risks. Solutions could be alliances and careful portfolio management. There are Venture Capital firms that refuse to invest in e-start-up's because they perceive it as too risky to follow today's hype.

2 Industry structure

The players and the market segments can be differentiated by a number of criteria, including time of investment (in the investees lifecycle), deals size and ownership of the Venture Capital companies.

For this article we use the time of investment as the most important criterion. Venture Capital investments can take place in almost every stage of a companies lifecycle to fulfil various needs for financing.

2.1 Market segments

For definition of the market segments – which are in this case tantamount to products – we will look at Venture Capital investments into the various stages of the investees lifecycles. The lifecycle modes is a tool to analyse products or industries, however, it can also provide insights into a company. The major phases or stages are embryonic, growing, maturing and ageing. Further subdivisions are possible. In this sense we define the following market segments/product groups:

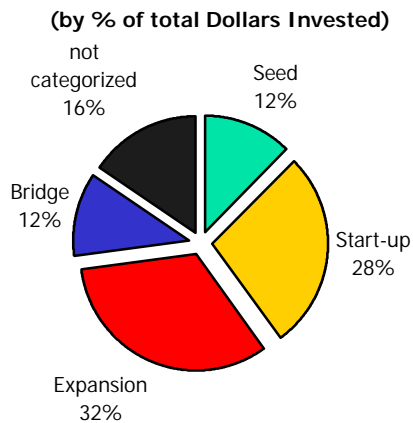
- Seed capital
- Start-up capital
- Expansion capital
- MBO/MBI and M&A capital
- Bridge financing capital
- Rescue capital

Seed capital and start-up capital are provided to finance the embryonic and early growth phases of a company. **Seed capital** is used to determine whether an idea is worth further consideration and to transform the idea into a working business concept. **Start-up capital** finances the foundation of the company and about the first year of its operation. Typical activities financed by start-up capital are prototype development and testing and test marketing.

Expansion capital supports companies in the growth phase which have already brought their products to market.

MBO/MBI and M&A capital is normally provided to more mature companies. It finances changes in the ownership of the investee, necessary to set the basis for further successful development. **Bridge financing** capital is determined to finance the expenses in the period before the IPO. Companies can also obtain Venture Capital to overcome economic problems. Measures to return to profitability and competitiveness are financed by **rescue capital**.

As an example, internet related Venture Capital investments are spread over the market segments as follows:



It is obvious that the largest volume of investments took place into companies in embryonic and growth phase. Arguably this is due to the industries lifecycle, which is still in growth phase.

2.2 The players

We define the following groups of players:

- Angels and angel clubs
- Venture Capital funds
- Small
- Medium
- Large
- Corporate venture funds
- Financial service venture groups.

2.2.1 Angels and angel clubs

Angels are wealthy individuals who invest directly into companies. They can form angel clubs to coordinate and bundle their activities. Besides the money, angels often provide their personal knowledge, experience and contacts to support their investees. With average deals sizes from USD 100,000 to USD 500,000 they finance companies in their early stages. Examples for angel clubs are

- eMedia Club
- Dinner Club
- Angel's Forum

2.2.2 Small and Upstart Venture Capital Funds

These are smaller Venture Capital Companies that mostly provide seed and start-up capital. The so called "Boutique firms" are often specialised in certain industries or market segments. Their capitalisation is about USD 20 to USD 50 million (*is this deals size or total money under management or money under management per fund?*). Examples are:

- Artemis Comaford
- Abbell Venture Fund
- Acacia Venture Partners

2.2.3 Medium Venture Funds

The medium venture funds finance all stages after seed stage and operate in all business segments. They provide money for deals up to USD 250 million. Single funds have up to USD 5 billion under management. An example is Accel Partners

2.2.4 Large Venture Funds

As the medium funds, large funds operate in all business sectors and provide all types of capital for companies after seed stage. They often operate internationally and finance deals up to USD 500 mio. Examples are:

- AIG American International Group
- Cap Vest Man
- 3i

2.2.5 Corporate Venture Funds

These Venture Capital funds are set up and owned by technology companies. Their aim is to widen the parent company's technology base in a win-win-situation for both, the investor and the investee. In general, corporate funds invest in growing or maturing companies, often when the investee wishes to make additional investments in technology or product development. The average deals size is between USD 2 million and USD 5 million. Examples are:

- Oracle
- Adobe
- Dell
- Kyocera

As an example, Adobe systems launched a \$40m venture fund in 1994 to invest in companies strategic to its core business, such as Cascade Systems Inc and Lantana Research Corporation. - has been successfully boosting demand for its core products, so that Adobe recently launched a second \$40m fund.

Excuse: Benefits and problems of Corporate Venture Funds

Many big companies are attracted to the Venture Capital model not only because of its impressive track record. More important is that it provides them improved access to business innovation, better retention or entrepreneurial talent and greater growth in the demand for their core products. Thus the corporations can capture more value from their strategic assets. By offering Venture Capital to companies with related businesses / operations companies can develop clusters of supporting industries (suppliers, customers, outsourcing partners, additional services, R&D centres) for their core operations.

However, many corporate funds do not achieve the same results as other Venture Capital funds do. Reasons are that they have:

- difficulties to establish the systems, capabilities and cultures that make good VC firms successful
- less freedom to fund innovative projects or to cancel midstream those that clearly won't live up to promise
- managerial skills for managing mature businesses but not for nurturing start-ups
- a lack of vital contacts in the start-up community
- a lack of contact to seasonal managers for the investees
- problems to find out the optimal time to sell out
- more hierarchical organisational structures that imply longer decision times than the more flexible Venture Capital funds have
- a portfolio management which is not ruthless enough in weeding out losers early; whereas Venture Capital funds are willing to cut losses on failing ventures immediately, corporate fund managers tend to perceive such actions not suitable to the companies policy or as admission of a mistake

adapted from: Paul Brody and David Ehrlich: Can big companies become successful venture capitalists? in The McKinsey Quarterly 2/98

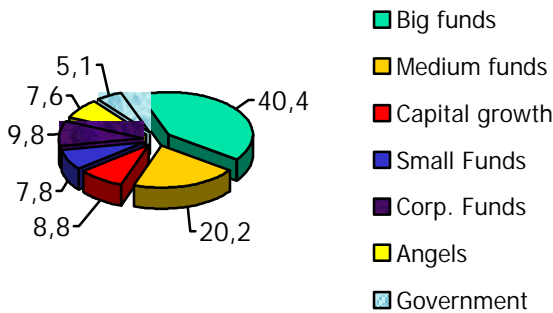
2.2.6 Financial services venture funds

These are Venture Capital funds set up by financial institutions. Thus they have access to resources from pensions funds and from their parent companies. Whereas their average deals size is USD 10 million to USD 18 million, they are focused on larger deals up to USD 75 million. Examples are:

- ABN AMRO development capital

- Fidelity ventures

2.2.7 The players structure

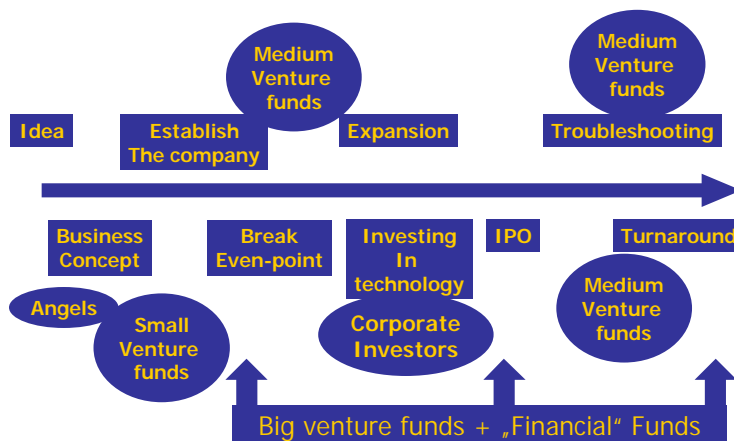


In 1998 the market share of these player groups was as follows:

An important factor is that in the Venture Capital industry as a whole as well as within the player groups there is no one dominant player. This is due to the element of risk that is inherent in every deal and becomes more important as the number and the volume of deals rises. As an illustration, in the segment of internet-related Venture Capital investments in 1999 the single funds show almost the same number of deals.

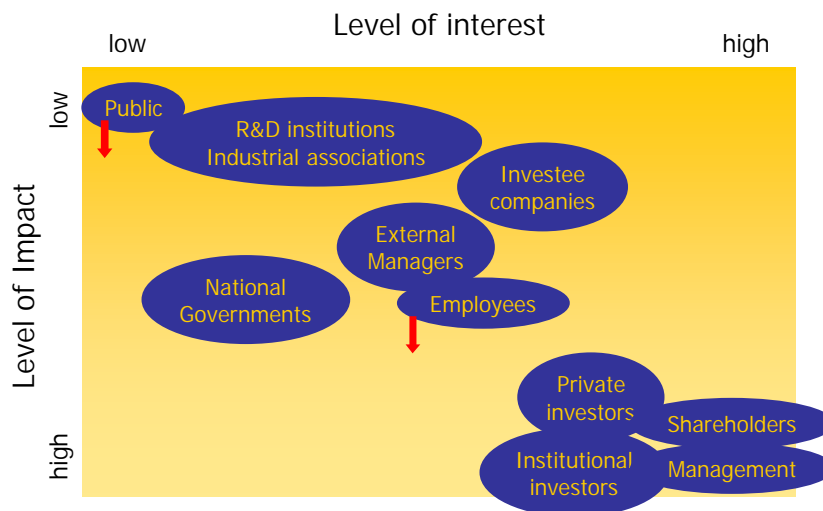
Fund name	Number of deals
New Enterprise Associates	24
Accel Partners	21
Draper Fischer Jurvetson	21
Bessemer Venture Partners	20
Chase Capital Partners	18

The following figure illustrates the market segments served by the different player groups



3 Stakeholder analysis

In the following stakeholder map we have arranged the most important stakeholders according to their interest in the industry/single companies and to their power to exert any impact.



We identified four major groups of stakeholders with similar interests and influence:

- Management / shareholders
- Investors
- Employees / investees / external managers
- Externals

Following we give an overview about likely interests and intentions of each group and give recommendations how the industry can develop and maintain good relationships with them.

3.1 Management / shareholders

They are interested in a stable and positive future development of their VC companies. Therefore they will carefully monitor all drivers and developments. In this young and dynamic industry we can assume that management and shareholders are willing and able to take immediate action and to develop new and creative strategies, e.g. alliances, mergers, new products. If it provides business opportunities or averts a threat they could even develop strategies that stretch the borders of their actual business. As long as their plans are not opposite the investors preferences they have sufficient power to implement their strategies. In a changing environment this group can be a driver for change in itself.

As long as the industry is growing there will be a need for qualified managers / partners. Excellent salaries, bonus schemes and other benefits are a means of attracting these people. A rising public reputation and awareness of the industry (similar to law firms, investment banks) could also improve the social status of the people working there, thus make the industry even more attractive.

3.2 Investors

In very general words they are interested in high returns. Besides that groups of investors can have other preferences as well, like the support for certain industries or technologies. With the expected globalisation and development of capital markets investors have a wider choice of investments. In addition, IT provides better access to information and better tools for analysing information. That's why we expect investors to become more critical and more interested in where their money is invested. Despite the high liquidity on that capital markets, which will provide enough funds for the industry as a whole, it will be harder to attract funds for those VC companies that have less impressive track records.

A good track record and good investor relationships will become even more important. Personal contacts are essential. Each VC company has to keep these key players informed and involved in major strategic decisions (as much as they wish to be). It is that simple: high returns are the most powerful means for attracting and maintaining investors.

3.3 Employees / investees / external managers

These groups interest focuses on the VC industry as an employer or business partner. In this sense we assume a fairly high interest of these groups. However, as long as these preferences are fulfilled, they won't have much interest in detailed strategies. With an expected overall positive development of the VC industry we expect it to remain an attractive partner for employees and external professionals. As a result of their power we expect that it will be easier to attract qualified people and good companies to invest in for those VC companies that are very successful or specialised.

With a rising competition for the really qualified people across all industries we expect salaries levels to rise. A good means for strengthening the relationship between the employees, external managers and also those top managers who are not shareholders would be stock options or the chance to become a partner. This would prevent these people to seek for other jobs or to open up a VC firm of their own (with all their contacts this wouldn't be impossible).

For a good relationship with the stakeholder-group of the investees – the customers – the whole mix of CRM is applies. We expect that made-to-measure-solutions will become even more important. Many institutions can provide money. The VC firms can/could provide more: experienced management, contacts within the industry, access to markets, to knowledge and to people. The better the venture capitalist can provide these values the better he can attract investees. This fact could lead to the development of new services for the investee firms. In addition it could be a driver for specialisation.

3.4 Other externals

In general they have a fairly low interest and power. Certain issues can have side effects on the VC industry, e.g. laws regulations or deregulations of capital markets, state programmes supporting R&D activities. Externals can form powerful interest groups and use lobbying as a means of exercising power.

VC companies have to identify the more powerful members of these groups and keep a good relationship with them. Information and PR are good means.

3.5 Summary

"Stakeholder management" will become more important for the VC firms. In order to attract qualified people and business partners and to develop a positive public attitude the VC industry will get more active in PR activities. They will develop new alliances, services and strategies and communicate them more active.

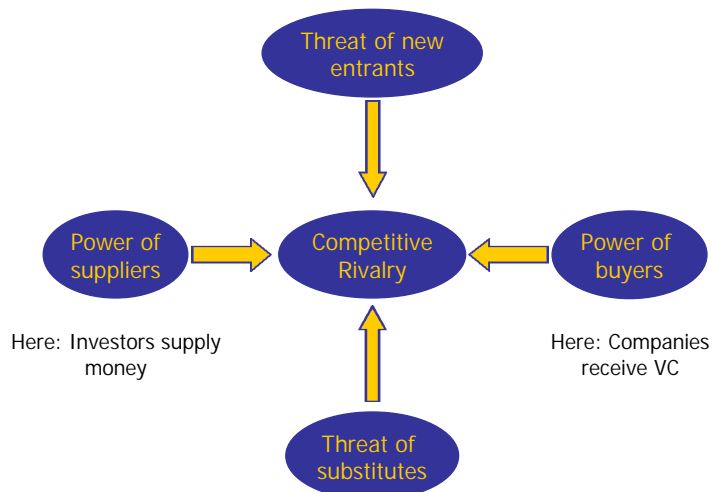
To fulfil the stakeholders expectations some VC firms will extend their product and service range, other will specialise to become leaders in certain market segments.

4 The industries external environment

In this chapter we discuss external forces and drivers that have impact on the Venture Capital industry.

4.1 Porters Five Forces

In general, this model is used to describe the attractiveness of an industry. Here it also provides additional information about the relationships amongst the involved parties.



Competitive rivalry within the industry: As mentioned, there are several market segments. A Venture Capital company investing in early seed stage does not directly compete with another one, investing in MBOs and MBIs. So between the segments the competition is moderate. It is more within the segments, between like and like. Of course, all together compete for money from investors and for experienced people. At present with the industry still in its growth phase we assess the competition between the players in general as moderate. Highly liquid capital markets and a growing number of start-up's provide sufficient business opportunities for the whole industry.

The industries high profits attract **new entrants**. Despite the money needed, this is not too difficult. If you have industry contacts and a good network, you can set up a new VC company. With today liquid financial markets it is not the problem to obtain funds. Thus especially people working in the industry for several years have the prerequisites to set up new companies. Besides that, other large financial and non-financial firms can take some money and set up a new VC firm as a means of diversification or for some other reasons.

The **power of suppliers** of money is not overly high because of the high liquidity of today's financial markets. On the other hand, it is very important for the Venture Capital companies to demonstrate a good track record of high returns to attract funds. The investment preferences of the investors influence, where they put their money in. And, equally important, all Venture Capital firms compete to attract expertise.

The "buyers" are the investee companies. The Venture Capital funds select them carefully and according to their own preferences to limit potential losses. Depending on the proportion of supply and demand for Venture Capital we assess the **power of buyers** as moderate to high.

There are hardly any real **substitutes** for the Venture Capital industries product, consisting of equity combined with management help, contacts and guidance. There are a few state programmes. Everything else lacks some of the unique features of Venture Capital.

All in all we see the competition in today's Venture Capital industry as moderate. However, this is mainly due to the growing industry. It could rapidly change as the industry matures and the growth slows down.

4.2 Drivers for change

Driver	Expected future development and Impact on Venture Capital industry
Development of technology, esp. IT and communication	<ul style="list-style-type: none"> • Will go on at a high pace • Broad variety of new developments; it is uncertain, which of these will become industry standards and which not • risk of failure for investees gets higher • harder to determine successful investments • Venture Capital firms need more expert knowledge in various fields

	<ul style="list-style-type: none"> • Shorter lifecycles for IT-systems lead to higher capital requirements • IT provides much easier access to information for everyone • Investors seeking for higher returns are better informed and take smarter decisions – money will concentrate at investments with the best track records • Knowledge, not money, becomes the key factor for a competitive advantage
Development of financial markets	<ul style="list-style-type: none"> • Rising liquidity leads to • More money available to invest • Higher prospects for IPO's • Rise of new / alternative forms of investments that compete for funds • If the first wave of e-start-ups starts to break down, the attractiveness of the whole industry for funds might decline, specialised and small Venture Capital firms will have problems • Rising integration, liberalisation on a global scale will improve the attractiveness and performance of financial markets in general, thus also boosting the Venture Capital industry
State of the economy	<ul style="list-style-type: none"> • Business cycles, economic up- and downturns influence the Venture Capital companies and all industries in which they invest • Economic upturn: <ul style="list-style-type: none"> • fuels growth and the number of start-ups – need for Venture Capital • high returns seek for re-investment – willingness to invest in Venture Capital -funds will rise • Economic downturn: <ul style="list-style-type: none"> • investors preferences will slide from high returns to stable returns – investments in Venture Capital funds loose attractiveness • companies need money for restructuring / recovering
Development of political climate for the economy, Globalisation	<ul style="list-style-type: none"> • Global deregulation of capital markets provides new opportunities • National protectionism and national subsidies programmes in some countries would make these economies less attractive for investments • Positive climate for education, R&D fuels new business opportunities and start-ups • Tax policy can have a huge influence on investment preferences and can change the attractiveness of Venture Capital-funds for investors in both directions • Globalisation drives scale • Requires huge investments in acquisitions and market development • Need for external expertise • Ongoing globalisation and liberalisation provide twofold opportunities for Venture Capital firms • Direct Venture Capital activities in new markets, e.g. eastern European entrants into the EU • companies go global and need funding for their international activities

In general, we see good prospects for the Venture Capital industry. Current growth predictions base on the expected pace of progress in IT and other new industries and on the expected ongoing globalisation. These developments bring across investment opportunities

- in start-ups and R&D based companies that drive the progress
 - in companies that have to invest
 - to keep their systems up to date
 - to adopt latest technologies
 - to stretch the borders of their industries and markets – both technologically and geographically
- In this more complex world excellent knowledge and state-of-the art information systems become vital for any Venture Capital company.

5. The Future of the Industry – Scenario I – Enough for all

Besides our general expectations for the future of the industry we have developed two scenarios for the next five years – one more positive and one more negative. For each scenario we show how the demand for Venture Capital might be effected and how the various types of Venture Capital companies could react to the changes in their environment.

5.1 The Scenario

Our "Enough for all" scenario predicts a positive future for the Venture Capital industry. It is mainly based on the further development of the IT industry in the widest sense.

The demand for even more user-friendly e-applications provides business opportunities for a wide range of IT-companies. In turn, a more and more convenient easy-to-use internet attracts more users. Internet traffic will continue to grow with high rates until the market is saturated. In the developed world, e-business and e-commerce become some sort of commodity. They are frequently used by individuals and corporations.

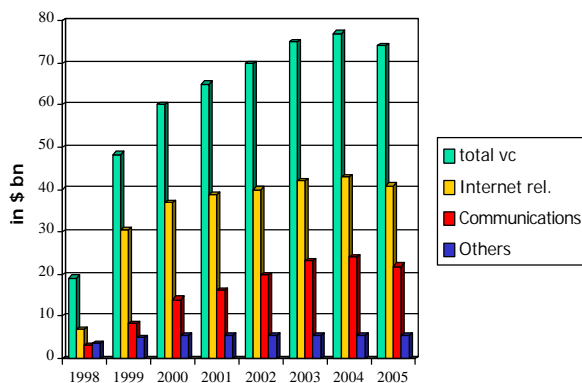
The so called "new economy" continues to prosper. Especially IT and related industries remain in their growth phase.

Governments in the whole developed world show efforts towards further liberalisation, harmonisation and globalisation. This creates a generally positive, optimistic climate at the international financial markets.

5.2 The Market for Venture Capital

The development of the major environmental drivers is favourable for the Venture Capital industry. The overall growth of the economy leads directly to a higher demand for Venture Capital. Since more people are encouraged to set up their own companies in R&D-intensive industries the demand for both – equity financing and external advise will grow.

The following figure is no exact prediction of the volume of Venture Capital investments; it intends to



show our expectations for the overall trend of the industry until 2005.

In this salutation, of the key success factors - deals size, profit, risk – balanced by excellent knowledge, deals size and profit become the more important ones. With a high proportion of successful enterprises the risk of failures in investments is still an issue but the focus is clearly on larger deals to obtain higher returns.

5.3 Solutions for the Player Groups

With the increasing demand for Venture Capital and the growing volume of money available the segment there will be an increasing number of **angels**. With increasing demand we mean not only more companies requiring Venture Capital, companies asking for ever higher amounts of money even in start-up phase. To be able to make larger and more profitable deals the angels and angel groups will form new larger co-operations and alliances, super angels. These super angels could even come together to oversized super angels.

As an alternative for angel clubs or super angels they can go together with **small venture funds** and limited partners to establish a new hybrid form of Venture Capital fund. Limited partners can be other angels and companies outside the high-tech industry which wish to invest their money without setting up an own corporate fund.

Many of the other funds will go global as the money and their investees do. This means that they will raise and invest money on a world-wide scale. Their strategy will be to co-operate in global Venture Capital networks. This enables them to operate in Joint Venture activities and to exchange information. The result of this shared knowledge will be higher returns.

6. The Future of the Industry – Scenario II – Hacker Attack

6.1 The Scenario

We have seen denial of service attacks on some of the most popular websites in the beginning of the year 2000. During the years 2000 and 2001 the number of hacker attacks will raise. Hackers demonstrate that they are able to enter companies internal systems and access encrypted data. The attacks become more than just a game to get reputation in their own scene; in short time they cause serious economic losses to companies and the society.

In the result both – corporate and private users of the internet – about their security and privacy. Since there is no really secure technology available the "e-economy" loses trust, the attractiveness of the internet declines rapidly. A large proportion of the e-business and e-commerce activities breaks down. In the years 2002 and 2003 many dot.coms break down, causing enormous losses on the financial markets. By the year 2004 this has led to a worldwide economic crisis.

6.2 The Market for Venture Capital

As we have shown before IT related companies are the most important clientele of Venture Capital firms of all size. These are the ones that are mostly affected by the breakdown of the "e-economy". Venture Capital funds face high losses. Following their poor returns it gets much harder for them to attract new capital. Investors preferences clearly shift to more secure investments. In addition, in times of economic breakdown there are less investment opportunities. Only the demand for rescue capital will increase. The trend of Venture Capital investments under this scenario is shown in the following

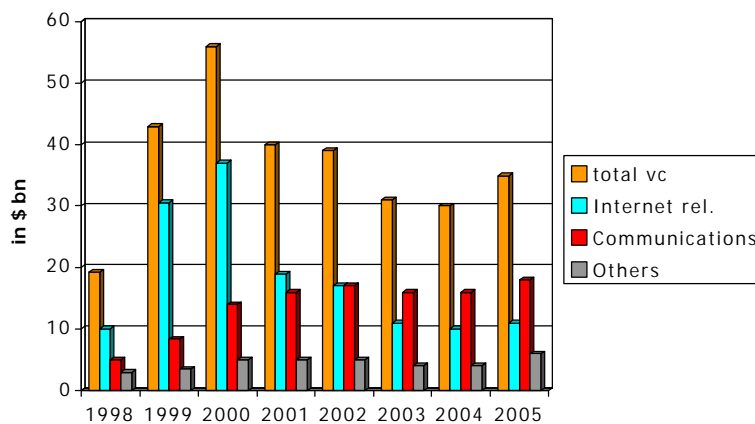
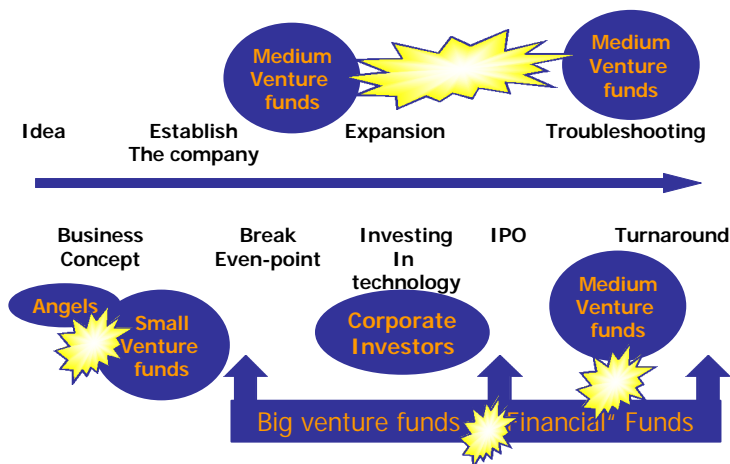


figure:

In this situation risk, or better risk management, becomes the most important success factor.

6.3 Solutions for the Player Groups

In a declining market there is no longer "enough for all". Every player group has to find new business opportunities and thus enters the markets of other groups. Competition within and amongst the player groups will increase. Players of all types will exit the market.



As for the **small and medium Venture Capital funds** strong competition will clear the marketplace. There will be mergers and acquisitions leading to a concentration of capital. Funds specialised in different business areas will form strategic partnerships. Only the more successful funds will be able to attract new money.

The **large funds** will try to improve their position by mergers and acquisitions with other funds to improve size, reputation and their financial muscle. In addition they will diversify. Possible areas to enter are other financial services by means of M&As with financial services corporations and the consulting business. For the latter one the funds have a rich resource of expertise and contacts in house. In a declining market for their core activity and with lots of tumbling companies out there is no reason why Venture Capital funds should offer advice and consulting only to their investees.

Financial and corporate Venture Capital funds find themselves forced to rethink their overall investment strategies. Most of them will change their strategies and preferences. Some of them might decide to exit the market. However, for the **corporate funds** there is still the need to get access to innovation and latest technology. With parts of the existing internet related technologies becoming obsolete¹ this could be more important than before. Hence we assume that a number of corporations will continue with their Venture Capital activities. A solution for **financial funds** could be a shift to a higher securitisation of Venture Capital activities. That means that the parent companies shift the risk to their customers by creating new products such as stakes in a Venture Capital fund. However, the success of such products will depend on the overall climate and expectations in the economy. As long as the downturn continues without any sign of recovery customers might prefer less risky alternatives.

7 Summary / Recommendations

We have demonstrated that the Venture Capital industry currently enjoys a very favourable environmental situation. There are good growth prospects that enable the players to increase their activities without major competition. However, as soon as the growth slows down – be it in one year because of some external events or in five years when the industry matures – times will become harder. To prepare for a stable long term developments Venture Capital companies of any type should

- Seek for alliances inside and outside the industry,
- Grow, but avoid too rapid developments,
- Improve their risk management systems,
- Continue to attract expertise for their own management.

¹ We understand obsolete here in the sense that there is no more demand for these products and that alternatives are required.