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Two Views of Venture Capital: The Investor

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The venture capital business is changing, again. Coincident with the rapid evolution of technology and industry, the venture capital business has, in its short history, reinvented itself and its image. The number of services has increased and grown more varied: among other functions, venture capitalists manage funds, analyze new businesses and make investments, advise executives, and assist with related tasks, such as recruiting. A glimpse into the brief life of the venture industry reveals a business growing in sophistication and suggests the directions of its future.

Early Money

In the 1970s, the high-technology industry was relatively young, but taking off. The few large institutions, such as Hewlett-Packard, IBM, and Xerox, had developed strong and reasonably consistent track records in this new field, but they continued to finance themselves in traditional ways, using hard assets as collateral for loans. Unfortunately, this financing model created barriers to entry for cash-constrained start-ups, such as independent software companies that needed to capitalize quickly on market opportunities.

Enter the concept of venture capital. The first generation of venture financing really began in the 1970s, with pioneers such as Arthur Rock revolutionizing the financing of high-technology, high potential companies. This new type of financing allowed investors, primarily wealthy individuals, to buy the stock of companies still in their infancy.

However, the relatively high level of risk was not for everyone. There were few assets to offer as security. Instead, these investors took equity in the company, essentially making collateral of the intellectual property and potential of a new firm. The early venture capitalists served as middlemen, or brokers, offering a service to the investors by locating promising opportunities and providing a unique financing method for entrepreneurs. In exchange for taking the risk and providing the capital, venture firms usually took positions on the board, with special voting rights, and held a substantial stake in the company.

IPO Heaven

The model worked. By the early 1980s, companies like Apple Computer, Compaq Computer, Lotus Development, Microsoft, Oracle Systems, and 3COM succeeded. Investment banks took the most promising companies public, and the public financial markets upheld the value.

The success of these early initial public offerings (IPOs) drove the second generation of venture capital. Venture capitalists refined the process of preparing a company for an IPO: the "package" now focussed on revenue growth and cash management. Where the early venture capitalists were useful simply because they were willing to invest, the value of this second generation lay in their expertise at transforming private companies into public companies.

Investor confidence grew as large returns were generated. This, in turn, attracted more investors, including not only individuals, but also other fund managers looking to enhance their investment portfolios. To increase the convenience for both investors and entrepreneurs, venture capitalists formed companies to create and market funds to prospective limited partners. These "limiteds," as they became known, would more easily be able to share in the rewards of the fund's success.

Rolling Up the Sleeves

The refinements made by the second generation brought results. More than 600 venture-backed companies went public from 1995 through 1998, according to VentureSource, an industry watcher for venture capital. Annualized internal rates of return, a metric most venture firms use to characterize fund performance, skyrocketed—in some cases topping 100 percent. The knowledge of how to take a company public became well understood throughout the industry. In addition, the limiteds of the second generation received strong returns on their investments. This prompted many more investors to share in the rewards of the stock market, thus making even more capital available to fund the opportunities. With this increased capital came increased pressure to generate similar outstanding returns in markets growing more sophisticated. Venture firms once more needed to enhance the way they conducted business.

Welcome the third generation of venture capitalism. Beginning in the 1990s, venture capital firms began hiring staff with executive operational experience. This has helped CEOs of start-ups to define their business strategies more clearly and to recruit the right talent for their companies.

Although not all the results are in, early indicators suggest success. Initial public offerings now take place much earlier in the life cycle of start-ups, and mergers are now far more common than IPOs, stemming from VC contacts not only on Wall Street, but also with corporations. According to VentureSource, the ratio of mergers to IPOs was 2.5:1 in 1998, up from 1.5:1 in 1997. In fact, venture-backed IPOs represented only 20 percent of all IPOs in 1998, down from 26 percent of the IPOs in 1997. The third generation of venture capitalists has developed both a strong sense of general business acumen and a wider range of financing options for young companies. In terms of return on investment, modern venture firms have not only been swinging for home runs (i.e., returning at least 20 times the investment), but willing to accept the doubles and triples of a merger (i.e., five to ten times the return).

Finally, in addition to offering better counsel to portfolio companies, VCs have begun to specialize. Some are focused on regional investments; others, on a particular technology area. Most are attempting to make investments earlier and earlier in the life of a company.

Tomorrow's VC

The year 2000 will likely see the beginning of the next generation of venture financing. With an even greater sense of focus, venture firms will continue to refine their investment strategies, not only in technologies and stage of investment, but also in vertical markets. At the same time they are narrowing their focus, the new venture capitalists will also be enlarging their scope of services. While still supporting portfolio companies with strategy and operations in the boardroom, venture firms will also be assisting companies at the functional management level. Indeed, the most innovative of venture firms are beginning to go so far as to loan members of their staffs to help with the "heavy lifting." Some have hired full-time recruiters to help portfolio companies—particularly in their formative stages—locate and hire the best talent.

Furthermore, this new generation of venture firms will not only identify, but also incubate interesting new investments, working closely with prospective entrepreneurs to create companies from scratch. Beyond that, venture capitalists will use a portfolio approach to administer the funds of the firm and to coordinate entrepreneurial investments. By crafting such a coordinated portfolio, these investors can manage the financial risk-return more explicitly, and a priori. That is, each venture firm will create and manage a portfolio of investments with a unique blend of technologies, investment stages, verticals, and geographies. In addition, firms will begin investing much more heavily outside the United States, as international venture funding becomes a reality.

This "full-service," global approach will define the next wave of venture capitalists. Once viewed as a necessary evil for funding companies with small windows of opportunity, the venture capitalists will continue to evolve in the next century as strategic partners of entrepreneurs.

Venture Capital Investment Top Five States, 1998

State	Number of Companies	Total Investment (millions of dollars)	Percentage of U.S. Venture Capital

			Investment
California	981	6,478.64	40.45
Massachusetts	296	1,801.08	11.24
Texas	139	841.61	5.25
New York	114	742.89	4.64
Colorado	85	601.83	3.76

Source: Data from Venture Economics and the National Venture Capital Association.

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1 April 1999

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