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VC Spending Spree

When the money is flowing, everybody seems to be happy. Therefore, it should not come as a surprise to hear Mark Heesen's ebullience when discussing the latest statistics put forth by the National Venture Capital Association.

Earlier this week, the NVCA published its findings on spending in the second quarter, declaring venture investment hit a record high since the first quarter of 2002 to \$6.3 billion in 856 deals, representing a 2% increase in terms of money and a 5% increase in terms of the number of transactions from the prior quarter.

Biotechnology, industrial and energy, and networking and equipment sectors saw the greatest jumps. Seed and early stage deals and expansion stage deals also grew from Q1. Finally, first-time financing reached a five-year high.

"I think we are going to continue to see early stage investing go up over the next couple of quarters," says Heesen, president of the NVCA. "As these companies mature, we will see an upswing in expansion funding and then in several more years after that and then you will see it in later stage [investing]."

Heesen's reasoning is that the increased numbers in venture capital spending are indicative of the fund raising cycle. As firms wind down their efforts to attract limited partner dollars they find themselves sitting on hoards of cash that need to be deployed. With so much money coming into the asset class, it is not surprising to see record amounts being spent.

Heesen has been extremely happy with the fund raising environment in the last few years, saying the venture capital asset class will probably end the year between \$50 billion and \$75 billion in money raised. Heesen

Despite the rosy numbers, the asset class could face some thorny issues soon

thinks the fund raising levels are pretty much right in the industry's sweet spot, comparing them with the more than \$200 billion raised during the previous cycle between 1999 and 2001.

"If [managers] said they were going to raise \$120 million, maybe they are raising \$130 million, but they are not raising \$250 million - which they could have done," says Heesen. "I think the market remains very disciplined."

Dave Reuter, a principal at LLR Partners, expands on what Heesen says. Reuter says the explosion of money into the asset class has attracted a lot of attention from people wanting their own slice of the pie.

"There [has been] a pretty big influx of capital in the last couple of years and as a result, there are more organizations out there that are continuing to deal," explains Reuter. "Everybody has money to put to work [and] somebody has to win the deal."

Despite the sunny forecast, not everything is coming up roses for the venture industry. To be sure, not all of the news is good.

For the increases in spending in biotech, sharp declines were witnessed in the venture spending in a few areas. Healthcare plummeted a whopping 66% to fewer than \$44 million in the second quarter from more than \$129 million in the first quarter. Financial services experienced a decline of nearly 50% in the same time from, dropping to less

than \$71 million from nearly \$141 million. Medical devices fell by 22% to \$549 in the second quarter from the first quarter.

"We have poor returns, but people are still chasing the asset class," says Jack Biddle, general partner from Novak Biddle. "Once the conventional wisdom becomes it is a poorly returning asset class, capital will be scarcer."

Biddle says, despite Heesen's assertions, there is just too much money in venture capital these days. Once the spigot closes a bit and there is less money in the asset class, returns will eventually rise since less money will be invested.

"I kind of teased Mark," explains Biddle.

"The question is not how much we are putting out, the question is how much we are getting back because we are supposed to be investors and people are supposed to get twice their money back."

Biddle says venture is earning about \$15 billion a year, but investing \$20 billion annually. He says this pace cannot be maintained.

"It is going to take a number of years until people realize returns are bad now because they are private companies and 12-year partnerships," explains Biddle. "Conventional wisdom and reality are usually four to five years apart."

Reuter cautions it is too early to forecast where venture capital will wind up. He points out the asset class generally follows the stock market, which has recently been choppy, at best. Should the stock market slow, as many have predicted, that venture capital smile could be turning upside down.

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