

A photograph of a surfer riding a wave. The surfer is wearing a wetsuit with yellow, blue, and red panels. The water is a deep blue, and the wave is breaking over the surfer, creating white foam. The surfer is looking towards the camera with a focused expression.

BY KARL RHODES

*The sharp rise and fall
of venture capital was a
wild ride for Fifth District
entrepreneurs and financiers*

The Venture

Dennis J. Dougherty is the founding general partner of Intersouth Partners, one of the most successful venture capital firms in the Fifth District. Based in North Carolina's Research Triangle, the company has been at the center of the region's high-tech transformation since 1985. But in 1999 and 2000 — at the height of the so-called "New Economy" — Dougherty was struggling to recruit the best and brightest from the nation's top business schools.

"None of the MBA grads wanted to work for venture capital firms," he recalls. "They all wanted to be dot-com CEOs!"

And why not? Everyone wants to join the entrepreneurial parade when venture capital is falling from the sky

like tickertape confetti. But when the technology bubble burst, corporate valuations came crashing down. Exit doors slammed shut on acquisitions and initial public offerings, and many venture capitalists were trapped in bad deals with no way out.

For a good portion of 2001, the industry was going through triage, says Jesse Reyes, vice president of product management for Thomson Venture Economics. "They have a stable with a lot of horses. They've already shot the bad horses, but before they put any more horses in the barn, they are going to have to let some roam the range, put them out to pasture, whatever you want to call it."

Nationwide, venture capital firms invested \$106 billion in 2000. Last year they invested \$21 billion, and this year that number is expected to fall even further. Based on first-quarter numbers from the National Venture Capital Association, venture capital companies are on pace to invest about \$15 billion in 2003.

"There are a lot of people out there who believe that the industry, for the next couple of years, would be very well served to be operating at the \$10 to \$15 billion-a-year level," says John S. Taylor, the association's vice president for research.

That may not sound like much money compared with \$106 billion in 2000, but it's exactly where the indus-



Adventure

try stood in 1997, when venture capital was all the rage.

In the 1970s, 1980s, and the first half of the 1990s, venture capital represented less than 1 percent of corporate financing in the United States, according to Taylor. During those decades, demand for venture capital began to outstrip supply as burgeoning technology sectors attracted thousands of entrepreneurs with ideas that were too risky and too specialized for banks and other traditional financial institutions.

This imbalance persisted until the mid-1990s, when market values for dot-com, telecom, and infotech companies began to climb rapidly, and investors

started throwing money at virtually any high-tech startup with plans to go public. In response, eager entrepreneurs scrambled to put together deals, many of them ill-conceived. Supply and demand surged simultaneously, and venture capital investments skyrocketed.

Even before this sharp rise and subsequent fall, venture capital had become a crucial part of the financial spectrum in the United States. Companies that received venture funding at some point from 1980 to 2000 generated 11 percent of the gross domestic product in 2000, according to a report by Global Insight Inc., a consulting firm based in Waltham, Mass. After adjusting for size, “venture-backed

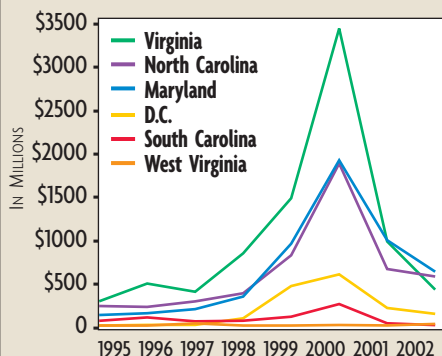
companies generate more sales, pay more taxes, export more goods and services, and invest more in research and development” than other companies, the report states.

With this much economic activity at stake, a prolonged slump in venture-capital financing would be cause for concern. Venture experts see some signs of recovery, but most of them are not predicting a quick rebound.

Venture capitalists are antsy to get back to fundraising, Reyes says. But they “are a little bit reticent to put in more money” until they see the exit markets pick up. “Without [exit markets], they can’t send money back to their investors.”

State by State

Venture capital flow to companies in the Fifth District.



SOURCES: Quarterly MoneyTree Surveys by PricewaterhouseCoopers, Thomson Venture Economics, and the National Venture Capital Association

Venture capital commentators have focused on the lack of demand for IPOs in the past three years, but the supply side of the IPO market also was tapped out, according to Harry Weller, a partner in New Enterprise Associates, a large venture capital firm based in Baltimore.

“You had a lot of companies IPOing very early in the R&D cycle. A lot of those failed. They didn’t get to reach maturity,” Weller says. “There was never

a pipeline created of maturing companies. They kept getting IPO’d or acquired.”

So supply and demand slumped at the same time, and “it took three years for companies to mature to a state where they started looking acceptable to a more conservative IPO market,” Weller explains.

Now, there is a pent-up supply of fairly good companies that are ready for the IPO market, Reyes agrees. “The IPO market probably would be more favorable to VCs than the merger market is. The merger market right now is looking for a lot of garage sales in the technology space.”

Reyes expects both the acquisition market and the IPO market to recover somewhat in the second half of this year, but he sees no reason to panic if the IPO drought continues. “Up until the mid-1990s, the IPO market probably ran second to the merger market in terms of the way VCs exited,” Reyes says. “So I don’t see any real danger if the IPO market [remains] down. That’s definitely the sexiest place to take your company. That’s definitely the place where you have the most upside... but with that comes a lot of uncertainty” because venture capital firms are required to keep IPO shares in their portfolios for a couple of years.

Acquisitions provide quicker, cleaner exits for venture capitalists, but buyers have become far more selective than they were three years ago. Even when the acquisition market recovers, “I don’t think it’s going to be about just buying companies for the sake of growing anymore,” Reyes says. “It’s going to be about [buying] access to technology.”

Weller is cautiously optimistic about the exit markets and the future of venture capital in general. “There could be more danger ahead. It could go either way,” he warns. “If the exit markets disappear for another five years, yes, capital will absolutely leave the venture capital industry and go to other asset classes. And you’ll see a lot of venture capital firms disappear. ... But I do think that the fundamental fact that innovation needs to be financed, and markets are created in this manner, is always going to be true.”

In the late 1990s, venture capital was the milk and honey of Northern Virginia, Southern Maryland, and North Carolina’s Research Triangle. Success stories abounded as venture-backed companies went public and created hundreds of instant multimillionaires.

Trying to replicate that success, civic leaders jumpstarted venture capital

From Angels To Exits: A glossary of venture capital terms

Angels – Individual investors who provide advice and venture capital (typically seed money and early-stage financing) to companies that interest them in particular. Angels tend to incur more risk than venture capital funds because they usually invest in one company at a time. To reduce that risk, many angels have formed angel networks.

Bridge Financing – Financing for companies expecting to go public within six months to a year.

Capital Calls – Collecting installments of money that investors have committed to a venture capital fund. This money is sometimes called “takedowns” or “paid-in capital.”

Capital Under Management – The amount of capital that a venture capital firm manages in all of its funds.

Corporate Venture Investors – Subsidiaries of non-financial corporations that invest in promising young companies that dovetail with the subsidiaries’ parent companies.

Early-Stage Investing – Purchasing ownership positions in companies that are refining their initial products or services. Typically these companies have little or no revenues, and they have been in business less than three years.

Exits – Opportunities for venture capital funds to cash in their investments. The two

most common exits are acquisitions and initial public offerings. Mergers are virtually synonymous with acquisitions.

Expansion-Stage Investing – Purchasing ownership positions in companies that have demonstrated revenue growth. These companies may or may not be profitable at this point.

Fundraising – Efforts by venture capital firms to secure financial commitments from investors to start a new venture capital fund.

Initial Public Offering (IPO) – A company’s first public sale of equity, usually in the form of common stock.

funds in other areas of the Fifth District, but their timing was terrible. “It was the harvest cycle. ...1999 and 2000 were great years to get out of deals. They were terrible years to get into deals,” Dougherty says.

One of these new firms, Richmond, Va.-based Monument Capital Partners, is not investing in any more companies. Meanwhile, two similar funds — Southwest One L.L.C. and Southside Rising L.L.C. — have joined forces under the management of Gryphon Capital Partners in Roanoke, Va.

Those two funds were formed to finance high-tech companies in Southwest and Southside Virginia. They have invested more than half of their combined capital in seed-stage and early-stage ventures, but they are struggling to find co-investors who are willing to shepherd these companies to the next plateau.

“We find ourselves somewhat alone,” says Leigh P. Huff Jr., a partner in Gryphon Capital. The firm is trying to raise money for a third, and larger, venture capital fund that would provide expansion-stage financing and act as a bridge to later-stage financing or acquisitions by larger companies. “Everybody is in general agreement that there is a need out there in the market,” Huff says. “People just have different ideas

about how to go about it. We don’t have any money yet [for the new fund], but in general conversations, there is a lot of support for the idea.”

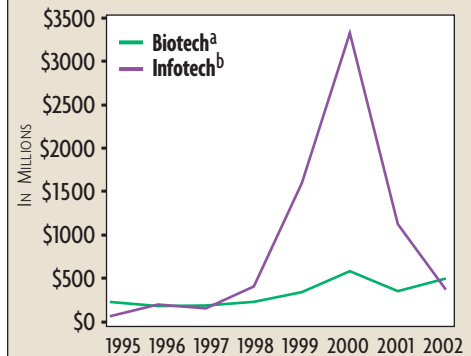
Gryphon Capital has expanded its territory to include Richmond, Charlottesville, Va., and Winston-Salem, N.C, but it doesn’t want to stray too far from its funds’ original geography. “We have tried to invest in companies that originated in the territories of those funds,” Huff says. The firm has backed several companies in Southwest Virginia near Virginia Tech, he notes, but “regrettably, we have not been able to do a deal in Southside Virginia.”

Venture capital funds that are restricted to underserved areas are at a distinct disadvantage, says Taylor at the National Venture Capital Association. “It’s tough enough to be a successful venture capitalist. If you restrict him geographically, it’s like tying one hand behind his back.”

Entrepreneurs and venture capitalists cluster together for good reason, says Dougherty at Intersouth Partners. For one thing, recruiting high-tech talent is virtually impossible outside of major concentrations of high-tech industry. Biotech, in particular, needs to be near major research universities that provide facilities and talent, he says. In the

Biotech vs. Infotech

Venture capital flow to the top two entrepreneurial sectors in the Fifth District.



^aBiotech also includes health care services plus medical devices and equipment.

^bInfotech also includes telecommunications plus networking and equipment.

SOURCES: Quarterly MoneyTree Surveys by PricewaterhouseCoopers, Thomson Venture Economics, and the National Venture Capital Association

Research Triangle, “without the universities, there wouldn’t be any venture capital, and there wouldn’t be any deals.”

Venture capitalists say that the capital craze of 1999 and 2000 was an aberration. They note that the level of venture capital investment in 2003 remains substantially higher than it was in the 1980s and throughout most of the 1990s.

Internal Rate of Return (IRR) – The discount rate that equates the net present value of an investment’s cash inflows with its cash outflows.

Later-Stage Investing – Purchasing ownership positions in companies that have solid revenues and positive cash flows. This stage may include spin-offs of well-established private companies.

Portfolio Company – One of the companies that a venture capital fund is backing.

Private-Equity Investing – Purchasing ownership positions in companies whose stock is not publicly traded.

Seed-Stage Investing – Purchasing ownership positions in start-up companies that are just beginning to develop their ideas into products or services. Typically these companies are not fully operational, and they have no revenues.

Small Business Investment Company (SBIC) – A venture capital firm that works with the U.S. Small Business Administration (SBA) to finance companies that qualify for certain SBA programs.

The Three Fs – The most common sources of seed money: friends, families, and fools.

Venture Capital – Private-equity financing from investors who support entrepreneurial

young companies that have the potential to become highly valuable large companies.

Venture Capital Firms – Private partnerships or closely held corporations that manage one or more venture capital funds. In addition to making investment decisions for these funds, venture capital firms advise the companies in their funds’ portfolios.

Venture Capital Funds – Pools of venture capital that are generally organized as limited partnerships. Investors may include pension funds, endowment funds, foundations, corporations, wealthy individuals, and the venture capital firms that manage the funds.

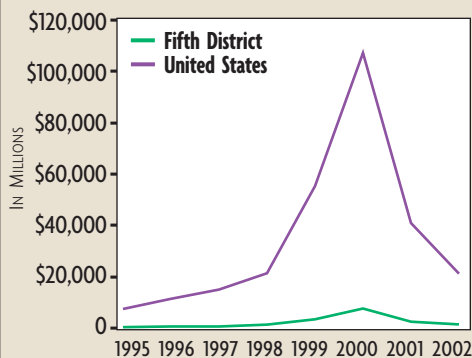
SOURCES: Thomson Venture Economics and individual venture capitalists

“When you look at what we had in 1999 and 2000, clearly those were economic conditions that were not sustainable,” Taylor says. “There were new areas that people were moving into, such as the Internet, and what we saw was that some Internet investments were very good, and many of them were very bad. And yet...the Internet has continued to grow and expand...and most of the technology behind the Internet comes from venture-backed companies.”

Many of those companies are in Northern Virginia. But overall, venture capital investments in the Fifth District are more diversified than those in other regions of the country.

The Rise and Fall

Venture capital flow to companies in the Fifth District and the United States.



SOURCES: Quarterly MoneyTree Surveys by PricewaterhouseCoopers, Thomson Venture Economics, and the National Venture Capital Association

“There’s a heck of a lot more medical, health, biotech, and life-science investing that’s going on in [the Fifth District] than in Silicon Valley,” notes Reyes at Thomson Venture Economics. “That kind of diversification has probably made the VCs in your district more sanguine than those I’ve seen on the West Coast, where the VCs went through a very deep financial, as well as psychological, depression.”

A big wildcard in the Fifth District is entrepreneurs’ ability to adapt their technologies to new homeland security and national defense needs, Reyes says. “We’ve tried quantifying that, and it’s a tough thing to do because the technology is so amorphous that it can be multipurposed pretty quickly. So where

someone was doing face-recognition software two years ago for corporate security, now he rebrands it as homeland-security technology.”

The flow of venture capital in the Fifth District has followed the same sharp downslope as the national trend in recent years, but the “amount of capital on the sidelines during this period is actually growing,” Weller says. “They are still raising funds in the Mid-Atlantic region—more so than most other regions of the nation.”

Even though these venture capitalists are sitting on piles of cash, “they probably have a good portion of that [money] earmarked for investing in old companies and relatively little of it earmarked for investing in new companies,” Reyes says.

The reason for that is arguable, Weller adds. “Some people say that a lot of that capital is really just...people not wanting to admit defeat.”

Venture capitalists in the Fifth District expect the region’s entrepreneurial sector to rise again, but opinion is split on how long that will take. “We think things have stabilized and that trends will be positive over the next few years,” says Jay Markley, a partner in Columbia Capital Corp., based in Alexandria, Va. “But we don’t expect a return to the gold-rush mentality.” Dougherty at Intersouth is a bit more optimistic. “I think it’s going to come back fast,” he says. “In the Fifth District, we have many experienced funds that are actively investing. Many of them are managed by entrepreneurs and former entrepreneurs.”

The venture-capital deployment curve has plummeted, but the venture-capital learning curve continues to rise. “The run-up of the dollars nationally has been a big benefit for the Fifth District, a region that was undercapitalized to start with,” Dougherty says. “There are certain watershed moments when things change, and we think that 1999 and 2000 was one of those watershed events. We witnessed a power shift away from Boston and California to the Southeast.”

Dougherty is particularly impressed with the rising quality of management



The Research Triangle area of North Carolina received a large share of the venture capital funds that flowed into the Fifth District during the 1990s.

in the region’s entrepreneurial sector. Experienced managers are bringing forward good deals, he says. “They have the wounds to show that they’ve learned some things, but they’re smarter and more realistic.”

Dougherty also sees a cultural shift that will make the Fifth District more conducive to venture adventures. “In the South, if an entrepreneur tried and failed, he lost his social standing in addition to his money,” he notes. “People wouldn’t invest in him again because they considered him a failure. On the West Coast, he was immediately hired because he had learned some things. It has taken us a couple of decades to overcome that mentality in the South. Now, pretty much everyone gets a merit badge for failure.” **RF**

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