GUEST ARTICLE

THIS YEAR'S VINTAGE WILL BE BEST ENJOYED AFTER 2010

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We will NOT see another bubble during this decade, thanks to lessons learned from past mistakes and to the fact that we simply won't have $200 billion with which to inflate a new bubble.

Metaphors for venture capital abound, but one of the most fruitful analogies may come from winemaking. Like wineries, venture firms cultivate a crop (a fund) on a regular cycle with which they craft highly nuanced products (portfolio companies) whose value grows with time. While neither can control the "climate" in which this work is done, both use experience and the regularity of the cycle to make informed predictions about the next "vintage year."

Currently, VCs are beginning the third year of the 2004/2006 fund-raising cycle. If the present pace continues in 2006, the venture capital industry will raise somewhere between $60 billion to $70 billion during this cycle. Compare this "cycle of discipline" with the 1999/2001 "cycle of exuberance" (when the industry raised $203 billion) and we can make some safe predictions about the near term:

In their search for the next "bubble-on-the-verge," the media continues to scrutinize investment upticks in the various industry sectors. Each in turn gets labeled as the next problem area: life sciences, systems security, social networking and, most recently, the Internet again. Fortunately, we will NOT see another bubble during this decade, thanks to lessons learned from past mistakes and to the fact that we simply won't have $200 billion with which to inflate a new bubble. Yes, we'll see some "frothiness" in particular niches, but concentrated investment in a sub-sector within reason creates the healthy competition that the venture industry thrives upon.

Many predicted that a large number of venture firms would sink to the bottom after the bubble burst and get filtered out by the post-boom market conditions. That hasn't happened. At the end of 2004 there were approximately 897 venture capital firms in the United States, down just 5% from the high in 2001. For good or bad and judging by the current fund-raising cycle's dynamics, a major reduction of firms during this decade seems unlikely. Institutional investors have maintained or increased their allocations to alternative asset classes while venture capital firms have decreased the sizes of their funds. This imbalance of supply and demand has left many limited partners either shut out of those funds they deem the most desirable, or bottled-up regarding the amount of money they can place with these funds. The overage is being spread out among smaller, and newer, but experienced, venture funds and ultimately to other alternative asset classes such as buyouts and hedge funds. It also means that limited partners may find themselves with more GP relationships, not less. And the role of funds-of-funds and placement agents may become more prominent as the decade progresses

In the third quarter of 2005, we saw continued strength in the area of later stage investing, consistent with the premise that VCs are deploying the last dollars of their previous funds as they begin to raise and invest their new ones. Yet, one has to wonder if the reserves required for follow-on and later-stage rounds will be available in 2010, given the fact that the funds this time around will be 35% of the size they were in the 1999/2001 cycle. If venture capitalists concentrate their funds on early stage, first-round companies during the next three years, they may very well find themselves out of cash and going back to LPs more quickly to support their later stage portfolio. Thus, the next cycle may be upon us sooner rather than many VCs are contemplating today.

Finally, the discipline that has been exercised by the venture capital industry in this cycle will manifest itself in continued strength in the hands of the general partners vis-à-vis entrepreneurs. Because there will be less money to go around, entrepreneurs will be asked to do more with fewer dollars. Entrepreneurs will need to prove themselves all the more to win additional rounds.

Through patience, discipline and expert cultivation, the venture community has positioned itself during this fund-raising cycle for a prosperous and healthy vintage in 2010.

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