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A Kink in Venture Capital's Gold Chain

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The high-risk, high-return venture capital business may have turned into all risk and no return.

That, in a nutshell, is the message that a prominent venture firm delivered yesterday to its investors when it told them that it could not continue to take their money — at least not for the time being.

"The traditional venture model seems to us to be broken," Steve Dow, a general partner at Sevin Rosen Funds, said in an interview.

Sevin Rosen, a 25-year-old firm that is among the most respected in the industry, was in the process of closing its 10th fund and had received commitments from investors for $250 million to $300 million, Mr. Dow said. But in a letter sent to those investors yesterday, Sevin Rosen said it had decided to abort that process.

"We have decided to take the radical step of returning the commitments you have given us for Fund X," the firm wrote.

Explaining its decision, Sevin Rosen, which has offices in Dallas and Silicon Valley, said that too much money had flooded the venture business and too many companies were being given financing in every conceivable sector.

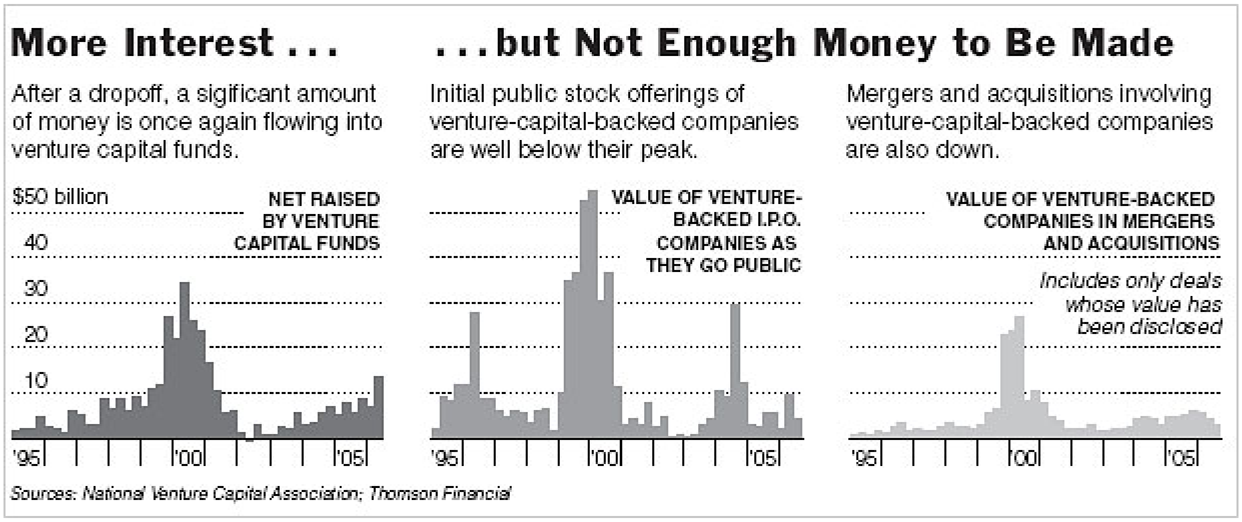
But excess of capital is only part of the problem, the firm said. In its letter, it bemoaned what it described as "a terribly weak exit environment," a reference to the dearth of initial public offerings and to a market for acquisitions at valuations that it considers too low to deliver the kind of returns that venture investors expect.

At a time when young companies like YouTube and Facebook are said to be entertaining acquisition offers in the $1 billion neighborhood, that pronouncement may seem surprising. But Mr. Dow said those "megadeals" were rare and were not enough to sustain an entire industry.

"While good returns from any given firm's portfolio is certainly a possibility, the statistics have clearly shifted in an unfavorable direction," the firm wrote. "The venture environment has changed so that overall returns for the entire industry are way too low and even the upper-quartile returns have dropped to insufficient levels."

Sevin Rosen's credibility is bolstered by the roster of companies it has helped lead to public offerings in the past, including Compaq, Lotus and Cypress Semiconductor. It has been describing adverse market conditions, to its investors and to the news media, for at least two years. But it finally decided that it could not be telling investors of a poor market for venture investing while continuing to take their money.

“If we really believe that there are fundamental structural problems in the venture industry, should we raise our fund and just hope that the problems will get better?” the firm wrote. The answer was no.



Many venture capitalists have voiced similar concerns for some time. And over the last few years, many firms have turned away far more money than they raised.

But investors, perhaps hoping for a repeat of the eye-popping returns of the late 1990’s, have continued to put money into venture firms. At the end of 2005, venture capitalists had a combined $261 billion under management, more than at any time in the industry’s history, though some of it was raised in the Internet boom.

Venture capitalists have given back money to investors before, most significantly after the Internet bubble burst and the appetite for investing in risky technology start-up companies nearly vanished. But experts say this is the first time that a top-tier firm has decided to scrap a sizable fund that was nearly complete.

“I don’t know of any other firm that has gone through that process,” said Mark Heesen, president of the National Venture Capital Association, an industry group.

In many ways, Sevin Rosen’s decision is based not on where the market for public offerings and acquisitions is today, but on where the partners in the firm think it will be in five or more years, the typical life of a venture fund. While Sevin Rosen has concluded that things are unlikely to change, many others disagree, Mr. Heesen said.

“That’s where the real debate is, and I can see V.C.’s on both sides of that debate,” he said.

Indeed, even as they say they wish there was less money in the business, and hence less competition for deals, many venture capitalists say they remain confident about their ability to make money for their investors.

"My job is to find the best opportunities we can find," said Kevin Compton, an affiliated partner at Kleiner Perkins Caufield & Byers, one of the top Silicon Valley firms. "In our opinion, there continue to be great opportunities."

And sitting on the sidelines is a risk that a firm with a strong reputation can afford to take, Mr. Compton said. If Sevin Rosen changes its mind and decides to raise a new fund, "there are plenty of people who will want to invest in it," Mr. Compton said.

Mitchell Kertzman, a partner at Hummer Winblad, a venture capital firm in San Francisco, said, "It is certainly true that there is a lot of cash in all parts of the venture capital supply chain." But that oversupply mostly affects sectors that are trendy, like the consumer Internet market, he said.

Many firms that have raised large funds have shifted their investments from "two guys in a garage" ventures to more established companies. Those "late stage" deals typically require larger investments but are considered less risky and offer the promise of quicker returns. As a result, this is "one of the best times to be an early-stage investor," Mr. Kertzman said.

Still, Sevin Rosen is known for investing in early-stage companies. While significant, the firm's decision to kill its latest fund does not mean it is closing shop. Sevin Rosen will continue to invest millions it raised in earlier funds. And Mr. Dow said the firm's partners planned to spend time thinking about new models of investing.

"Maybe there are different financing structures," he said. "Maybe we have to look at fund sizes. Maybe we have to look at only doing deals that are going to take a limited amount of capital."

At least one of Sevin Rosen's investors appears satisfied with the firm's decision.

"I think they are raising the right questions," said Sandra A. Ell, treasurer and chief investment officer at the California Institute of Technology. "It's not that there is a lack of investment opportunities," she said, but rather "a lack of being able to pull out your money" through public offerings or large acquisitions.

While Sevin Rosen may have raised the good questions, Mr. Dow admitted that for now, it lacks any good answers.

"We have properly diagnosed the problem, but haven't figured out for this patient what the therapy is," he said.