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VENTURE CAPITAL COMPETITION TO HEAT UP IN 2005

NVCA President Heesen Predicts New Business Cycle Will Fuel a Dynamic Year As Firms Choose Investment Strategies

December 14, 2004, Washington, D.C. -- The beginning of a new business cycle and a high demand for participation in the venture capital asset class will foster a strong competitive environment among VCs and limited partners alike in 2005, the National Venture Capital Association (NVCA) predicted today. According to Mark Heesen, NVCA President, the year will be characterized by a return to early stage investing as new funds are raised and those dollars begin to be deployed.

"We will enter a new business cycle in 2005 when many venture capitalists will have fresh funds to invest and that has several implications for the asset class," said Heesen. "At this time in a new fund's life, there isn't the pressure for immediate exits. Thus, venture capitalists have the opportunity to search for those seed, startup, and early stage companies that have the potential to truly change the way we live and work in the next decade – the future FedExes, Intels and Genentechs."

The shift to earlier stage investing also means a return to "*stealth mode*" as venture capitalists look to capitalize on first-to-market advantages for their companies.

"There will be some very exciting investments in highly innovative spaces in 2005 – ones that will make a permanent impact on the US economy," said Jim Breyer, Managing General Partner of Accel Partners and NVCA Chairman. "Yet some of the most compelling new companies may be the ones you don't hear about for some time."

Despite a healthy market, the bar remains high for companies looking for venture investment. Venture capitalists will be searching for true breakthrough innovations and will be avoiding "me-too" deals.

"Value creation will be paramount in company formation," added Tracy Lefteroff, global managing partner of the venture capital practice of PricewaterhouseCoopers. "Good ideas will not be good enough as competition for funding remains fierce. Gone are the days when ethereal ideas got seed money, just to flesh them out. In 2005, even start-up companies had better have some meat on their bones if they are to attract venture capital."

Competition will not be limited to the investment side of the venture capital equation. Fundraising will continue in earnest in 2005 as a high demand for participation in the asset class persists. Due to the smaller size of funds raised, limited partners will compete strongly for spots in the best performing funds. First time funds raised by industry veterans are also poised to do well.

“The NVCA will continue to caution the industry against raising more money than can be invested successfully,” warned Heesen. “Many funds will be faced with the prospect of being oversubscribed; discipline will be critical in 2005.”

One area that is in question is the future structure of the limited partner investment base as the industry considers the challenges of accepting public pension money in wake of recent disclosure rulings.

“2005 will be the defining year for the venture capital industry’s relationship with public-entity investors,” said Joe Aragona, General Partner at Austin Ventures and NVCA Chairman Elect. “All parties must find a workable balance between the public’s need for investment accountability and the confidentiality required to succeed in nurturing the next generation of our economy’s leading companies. Self-elimination from the asset class by overzealous, unnecessary information disclosure policies will have significant public policy and economic consequences for those limited partners who fail to acknowledge the requisite level of confidentiality for their general partners to be successful with their portfolios.”

Technology will continue to be the cornerstone of venture capital investing in 2005 with an ongoing focus in software and the life sciences sectors. Emerging areas such as stem cell research and nanotechnology will continue to be watched closely by the venture capital industry, although investment in these companies will be limited until more basic research and development is completed. However, new promising areas of investment include energy, clean technology, and financial services.

The exit markets will continue to improve in 2005 despite a questionable economy and Sarbanes-Oxley issues. Much of the improvement will be attributed to IT companies, which comprise 60% of all venture investment, gaining traction this year. Additionally, 2005 will begin to see more “phoenixes” rise from the ashes of the dot-com crash as strong, viable organizations ready for public investment.

“Many venture capitalists and entrepreneurs will be vindicated in 2005 as their companies that were funded in 1999 survived the “nuclear winter” and are now ready to go public or be acquired,” said John S. Taylor, vice president of research for the NVCA. “These organizations and others will help drive higher cash distributions back to limited partners and ultimately contribute to improving returns for the industry.”

"If the last few months are any indication, 2005 should be an encouraging year as the IPO and M&A markets continue to open the door for venture capitalists to exit out of their portfolio companies profitably. The combination of a growing economy, accelerating earnings growth and rising equity prices is making for a ripe exit environment.", said Sandra Ribeiro, Research Director of Thomson Venture Economics. "The focus on later stage financing in companies in the past few years has allowed a pool of companies with strong financial statements to become eligible for exit opportunities".

As the industry has stabilized, venture capital firms will be considering their own strategies for the coming decade. Structurally, the decline in the number of firms will not be as precipitous as some had suggested. Rather, in 2005, the NVCA predicts the industry will begin to bifurcate into two types of firms.

"We will continue to see the large, global, cross-industry firms at one end of the spectrum with smaller, highly-focused firms that concentrate on a particular region or industry at the other," said Heesen. "There will be successes clustered at both ends with those in the middle needing to compete aggressively for the best deals."

NVCA members see 2005 as a year of opportunity in many areas as evidenced by the following predictions by a number of leading venture capitalists:

On compelling investment sectors:

"The telecomm market will pull a Rip Van Winkle and awaken from its three years of slumber. Having skipped a full generation of technology, the market will rebound in earnest."

-- Chad Waite, OVP Venture Partners, Kirkland, WA

"Biotechnology has emerged as the white knight of the venture capital industry. Historically, information technology liquidity has been robust, but current biotechnology liquidity will outperform IT liquidity by 2X. Within life science, clinical stage pharmaceutical products now represent nearly 90% of all IPO's, which is up from 50% in the 1999-2002 timeframe. This trend will continue. Even with the scientific advances of recent years, we are an aging population suffering from dozens of underserved diseases. It is the diversified venture capital funds investing in counter-cyclical sectors that will provide consistent, top-quartile liquidity. Biotech is here to stay."

-- Jim Healy, MD, PhD, Sofinnova Ventures, San Francisco, CA

"Private equity and venture capital firms will continue to be attracted to established Internet companies, particularly those companies who have proven business models and have demonstrated profitability and positive cash flow. Software companies that deliver products as an On-Demand service are also expected to be attractive to investors as corporations seek to minimize the upfront investment and deployment time to implement an application. Outside of technology, the financial services and consumer services space is expected to provide attractive opportunities as is the healthcare services sector especially companies that serve to reduce healthcare delivery costs and increase the quality of care."

-- Walter G. Kortschak, Summit Partners, Palo Alto, CA

"*The results of our recently fielded "FTVentures" IT Outlook, a survey of our financial institution Limited Partners who control 1/3 of the world's financial industry IT spending, indicate that the new year will continue to show plenty of promise for companies offering solutions in the areas of compliance, business continuity and security. Storage needs, driven by the stricter regulatory environment, are up a whopping 50% at most corporations. We also see opportunities for companies with business intelligence offerings for revenue growth and cross channel initiatives, an area our LP's told us they will ramp up in 2005."*

-- Bob Huret, FTVentures, San Francisco, CA

"I predict an increase in biotechnology mergers, acquisitions and broad strategic alliances including 4 to 6 sizable deals in 2005. I see this as part of a trend in which larger biotechnology and pharmaceutical companies are turning naturally to smaller biotechnology companies to fill their research and development pipelines."

-- Farah Champsi, Alta Partners, San Francisco, CA

On the promise of innovation:

"Advertising as we have known it is over. Brand owners need to go where you are, and that isn't on network television or the newspaper. In order to promote their brands and attract and maintain relationships with consumers, brand owners will have to come to you, on your wireless device, with your media stream, on your pc. In addition, they'll have to follow you wherever you go -- into the retailer, the entertainment venue, or your place of business. As this revolution occurs, it will create huge opportunities for those companies who have created compelling in-venue experiences that can incorporate brand messages in a seamless manner. Also to benefit will be those companies who have created new and interesting ways to make brand advertising fun, unobtrusive, personalized, relevant, and continuing for the consumer."

-- Heidi Roizen, Mobius Venture Capital, Palo Alto, CA

"2005 will be a year of significant change in digital media on the home front. As broadband bandwidth and penetration increase, companies will explore new ways to access and share content throughout the household that was previously trapped inside the PC. The shift from traditional televisions to LCD panels creates a gateway for personal and public content to move out of the home office and into the center of family life. The volume of photos, videos, music and other digital content will continue to grow exponentially, and businesses that can help users easily find, purchase, enjoy and protect the files that matter most to them will see big opportunities."

-- Joanna Rees-Gallanter, Venture Strategy Partners, San Francisco, CA

"Biometrics, and in particular fingerprint recognition, will emerge as an exciting new end-user technology in 2005. Trying to remember an ever-expanding set of passwords is becoming a hopeless exercise, driving people to self-defeating practices such as posting notes on one's computer. Fingerprint recognition is a cheap, easy-to-use and effective way to replace passwords with a technology that guarantees access to those who are authorized. The recent product introduction by Microsoft, which quickly sold out in many computer stores, validates the consumer opportunity, while young companies like Digital Persona, Upek and newly-public Cogent are demonstrating that fingerprint recognition technology is a priority for both enterprise and government."

-- Alessandro Piol, INVESCO Private Capital, New York, NY

"*Biology is a complex beast. The entrepreneur community is in the early, but very promising stage of applying innovative cross-discipline approaches that examine the myriad differences in* *individual makeup so that one day soon diagnostics and therapies will move beyond 'one-size fits all' and to better, focused and more personalized medicine."*

-- Bill Ericson, Mohr Davidow Ventures, Menlo Park, CA

"2005 will be the year when having your computer network or enterprise software application up and running 99.9% of the time won't be good enough anymore. Users and top management will demand 99.999% reliability, otherwise known as Five 9s reliability -- the kind of always-on functionality you expect from your telephone or your TV. That means CIOs will have to reduce downtime from an average of 8 hours and 45 minutes per year to no more than 5 minutes and 15 seconds per year. It's a tall order."

-- Shanda Bahles, El Dorado Ventures, Menlo Park, CA

On overseas investment:

"We see U.S. venture capitalists investing more overseas in 2005. This trend will grow as domestic investing gets harder and venture capital becomes more plentiful. But our experience over 36 years is that investing overseas is inevitably more difficult than investing at home. We think the more effective strategy for dealing with the growth of foreign markets is to invest in U.S. companies with innovations in materials, energy, consumer electronics, biotech, and medical devices that foreign markets will buy."

-- Bob Pavey, Morgenthaler Ventures, Cleveland, OH

On VC and the economy:

"2005 will bring a new spotlight onto venture capital, and not just because of FOIA or Sarbanes Oxley. These hot burner issues are also highlighting the good aspects of VC participation and many entities are investing in venture capital expecting strong IRR's. Additionally, the general public will become more aware of the "humanitarian side" of venture capital because of the bridge it provides from innovation to job creation. And as our politicians know, it's all about jobs, jobs, jobs. Combining the recovering economy with more available capital, venture is looking to have a strong year. "

--- Thomas Gephart, Ventana Capital Management, Irvine, CA

On the health of the market:

"We see no evidence of back to bubble period behavior or attitudes in 2005. Rather, it is a back to the future attitude - really a return to pre-bubble normalcy. Venture funding will continue to rise in 2005 but VCs are still understandably cautious. The challenge will be to avoid investing too cautiously, while maintaining the tenacity and guts it takes to back and build the market leaders of tomorrow. So it's steak, not sushi. Martinis, not Dom Perignon."

-- J. Sanford Miller and Allan Ferguson, 3i, Menlo Park, CA and Waltham, MA

"In 2005 the venture capital industry should witness a continuation of the current recovery as public capital markets continue to strengthen and as buyers of IT equipment and software gradually increase expenditures. The venture capital industry's fund raising and investment pace have now returned to long-term sustainable levels which will help the outlook for stronger industry returns."

-- Peter C. Wendell, Sierra Ventures, Faculty Member, Stanford Business School, Menlo Park, CA.

On availability of capital:

"The number of existing and new firms raising funds that will be put to work in 2005, coupled with the return of true mezzanine investors anticipating the coming exit market, will result in an increase in the number of investments in seed and early-stage companies. Deal size probably won't increase substantially, given that many of these new funds are smaller than their predecessors, but there will be more cash flowing into the market – and it will be good news for very young companies."

-- Dennis Dougherty, Intersouth Partners, Durham, NC

"I expect to see a relative increase in the availability of venture capital in emerging markets over the next five years - spurred by multiple state fund of fund initiatives in these markets and an overhang of venture dollars in the top ten markets."

-- David Mann, Spring Mill Ventures, Bloomington, IN

On VC at a cross roads:

"*Virtually all of the returns in the industry over the past 40 years have come from the Information and Communications Technology (ITC) sector with capital spending in that sector growing at nearly 3x the rate of GDP growth. ITC capital spending now represents almost 40% of all capital spending and I expect it in the future it will it grow at or near the same level as the GDP. ITC is a mature industry!*

Venture capitalists must find new industrial segments which are growing at a significantly faster rate than the GDP. Is biotech the answer? Either that, or we VC's will have to outperform the GDP through shear brilliance. If we don't, returns for the industry will decline to match other investment options."

-- Bill Stensrud, Enterprise Partners Venture Capital, La Jolla, CA

The National Venture Capital Association (NVCA) represents approximately 450 venture capital and private equity firms. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy, and support entrepreneurial activity and innovation. According to a 2004 Global Insight study, venture-backed companies accounted for 10.1 million jobs and $1.8 trillion in revenue in the U.S. in 2003. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provides reliable industry data, sponsors professional development, and facilitates interaction among its members. For more information about the NVCA, please visit www.nvca.org.