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*Spanning the Chasm from Thought to Action*

## **Digital Bridges2005**

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### **The Internet: More Than a Tool for VC?**

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The Venture Capital (VC) community experienced massive change both as a result of the Web itself and the equity boom that the Internet created. In 1997 there were 515 funds with a total value of \$65 billion, employing nearly 5,000 people. Just three years later the number of funds grew to 1,027 and the total capital under management was a staggering \$246 billion.<sup>1</sup> Industry participants dispute the reasons behind this influx, though it is difficult to ignore the tremendous attention that VC – and its successful financial returns – garnered as a result of the Internet Bubble. The presence of more firms, teamed with many of the tools provided by the information age, has dramatically re-shaped the manner in which entrepreneurs seek funds. Furthermore, the technology sectors receiving funds continue to change annually. Finally, while the

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<sup>1</sup> Database Source: VentureXpert database from Thomson Venture Economics  
Investment Data Source: The MoneyTree Survey by PricewaterhouseCoopers/  
Thomson Venture Economics/NVCA

Internet altered many aspects of VC, it did not change other characteristics, such as the desire to fund startups located near the financier's office. Indeed, the Digital Era has left a curious footprint on the VC world.

### **Transparency and Hyper-Competition**

Before the proliferation of the Internet, the Venture Capital industry was relatively enigmatic in the eyes of entrepreneurs. Experienced managers generally held close contacts within specific VC firms, and the process of receiving funds proved arduous for those who had not been introduced into the relationship-based venture world. Furthermore, many of the top players in the industry maintained a broad portfolio of investments; though VC has always been associated with technical innovation, top-tier firms pursued software, telecom, healthcare, and many other cutting-edge fields.

As a result of the Web's emergence, the significance of the relationships between VC's and entrepreneurs has changed. It has become much easier for company managers to shop around for a valuation, and those with truly novel ideas may find themselves entertaining many potential VC suitors. This is partly because basic Internet tools, such as email and corporate homepages, have made it easier for those who have received VC attention to contact other financiers and solicit a potential valuation. The result of this is the creation of an auction environment, whereby a dozen potential investors will have to propose competing offers in hopes of funding a top entrepreneur. This is a far cry from the days in which entrepreneurs went to their trusted VC and negotiated a seemingly fair valuation.

Further benefiting entrepreneurs has been the tremendous influx of capital into the VC world that was brought about by the success of startups during the Internet boom. Some would argue that this hyper-competition was initiated when the increase in dedicated VC capital began to outweigh the increase in ideas and innovation, meaning that more money began to chase fewer quality deals. One piece of evidence supporting the presence of hyper-competition is the large presence of capital overhang – money raised by VC that has not been invested – which now stands at a record \$68 billion. Many VC funds have policies in place that require them to invest funds within five years of raising them. This means that much of the capital overhang that currently exists is made up of money that was raised during the Internet boom.

The tremendous research capabilities provided by the Internet have also affected VC funds. Before the advent of the Web, it was more difficult for VC principals to perform due diligence on potential investments. One of the most difficult processes was the investigation of potential competing startups. Today, a simple Google search can provide the investor with a great deal of knowledge with regard to a specific technology and the companies possessing it. Simply stated, it takes a lot less time for a VC fund to figure out whether an investment makes sense, though they do not necessarily make investment decisions faster. What is less clear is whether this has put more pressure on principals to execute a placement. Some VC principals claim that they do not feel obligated to 'pull the trigger' any quicker than they did in the pre-Internet days, while others insist that they must move faster than they did before.

## Venture Capital Reaction

How have VC funds responded to the new environment forged by the Internet? One response has come in the form of specialization. Unlike early VC funds, which were willing to invest in many different industries, many new financiers are focusing on specific areas. This allows them to add value beyond the money that they dole out. Many entrepreneurs will be attracted to a fund that can boast first-rate contacts and principals who have impressive industry experience.

For those that consider themselves to be among the top-tier VC funds, one reaction has been simply not to react. The recent decrease in VC returns, while painful for long-time principals, can be endured so long as it is temporary. As many of the recently-arrived funds continue to struggle, it would seem that traditional economics might predict their eventual market exit. Still, there exists a perception within the industry that the ‘secret’ of VC is finally out. What was once considered a “cottage industry” is rapidly becoming institutionalized as it grows beyond the confines of Sand Hill Road in Silicon Valley and the route 128 belt in Massachusetts. In recent years, the VC industry has grown significantly, garnering attention not only from would-be participants, but also from everyday investors and consumers who knew very little about VC ten years ago.

### Shifts In Funding:

Those who make decisions within a typical VC fund are acutely aware of cycles within different technology sectors and are constantly seeking to figure out ‘what’s hot.’ There have been a number of compelling changes in not only the amount of VC capital looking for a home, but also in the types of companies into which VCs choose to invest. These changes have grown out of lessons learned by the Bubble that brought seemingly-unrealistic returns and then declined overnight – erasing the community’s confidence in Internet companies. When comparing sectors that have received VC funding in both 2000 and 2003, there is strong evidence to support the notion that VCs took a step back from certain types of investments and herded into others. The strongest changes in total share of VC capital placement have been seen in:

	2000	2003
Telecom:	21%	11.3%
Retail and Consumer:	8.4%	1.7%
Biotech/Healthcare:	9.8%	31.0%

There are several possible explanations for these changes, with one being that VCs may have made the switch from what appeared to be lucrative, quick-turnaround opportunities to more secure, long-term options. During the Boom, the biotech and medical devices industry was not seen as the most attractive investment as the number of IPOs in Internet companies grew. Healthcare devices require more time to come to market and were thus seen as less attractive investment.

As the figures above on healthcare indicate, however, the sector is now one of the most heavily funded industries. This is due in part to the fact that many companies in this field are able to protect themselves by applying for patents. This makes the investment more secure and gives the company an intellectual asset, the value of which can be quantified. If all else fails, the patent can be sold or licensed. In addition to this, the Internet has made it easier to both apply for patents and research companies that may hold other patents in the same field. Indeed, the shift towards investing in the healthcare industry underscores the desire of VCs to find secure, long-term companies, as opposed to risky, mega-growth opportunities.

### **Where The Internet Is Not Driving Change**

The arrival of email and video conferencing was heralded as a revolution that could conceivably impact most aspects of how a company operates. In the VC world, it has failed to alter certain key modes of practice. Intuitively, one might expect the physical distance between a venture capitalist and an entrepreneur to be rendered less relevant by Internet innovations, but this has not been the case. While the Internet has been a key driver in terms of making many industries more global, the venture industry has remained one that sees the merit in being able to work directly (face-to-face) with entrepreneurs. By being close to the entrepreneur, venture capitalists are able to be active board members and are able to help in making critical corporate decisions.

There is a critical need for funding in locals outside of the Silicon Valley and the route 128 belt, where VCs tend to cluster. 2004 data released by the National Venture Capital Association (NVCA) indicated that nearly 49% of all investments were made in California. Massachusetts had the second greatest portion of investments amounting to 14%; while Texas, Washington and New York trailed with 6%, 5%, and 4% respectively.<sup>2</sup>

Programs such as Village Ventures attempt to find ‘diamonds in the rough,’ by putting offices in less developed communities. These satellite offices receive funding from limited partners located in major cities such as New York or Boston, and are able to fund entrepreneurs in less traditionally funded states such as Vermont and New Hampshire.

In keeping with the traditional idea that VC principals value relationships, the Internet has not made it easier for unknown entrepreneurs to gain funding for ideas of questionable merit. Though it is easier for strong entrepreneurs to shop around a valuation once they have received attention, this does not mean that unsolicited business plans evade VC recycling bins. Most principals agree that business plans arriving by email without a personal introduction are usually deleted immediately.

Though the Internet led to a complete transformation of many industries, within the Venture Capital world, the Internet has had a mixed impact. Despite gaining exposure by way of the Internet, the VC industry remains one heavily dependent on personal

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<sup>2</sup> [www.nvca.org](http://www.nvca.org)

contacts and relationships. Furthermore, even though some experienced entrepreneurs are now able to leverage VC offers against one another to drive up valuations, other less-experienced innovators are no better off than they were in the pre-Internet days. Email and other electronic forms of communication have facilitated the manner in which entrepreneurs and VCs share information, yet they have not provided a medium by which VCs feel comfortable funding projects outside of their geographic region. Finally, the dot-com boom and bust undoubtedly left an indelible mark on the industry and has created more savvy investors, who are less willing to jump into seemingly attractive deals.

### **Key Links**

<http://www.pwcmoneytree.com/moneytree/index.jsp>

<http://www.ventureone.com/>

<http://www.ventureeconomics.com/>

<http://www.nvca.org/>

<http://www.kpcb.com>