INDUSTRY VENTURES

White Paper

The Venture Capital Rebound

How to Generate Outsized Returns 2009-2019

Roland Reynolds, Principal
roland@industryventures.com

Ken Wallace, Vice President
ken@industryventures.com

September 2009

© 2009 Industry Ventures, LLC

INTRODUCTION

Two key trends have dramatically altered the venture capital industry over the last three decades: the rise of larger fund sizes and the decline of Initial Public Offerings (IPOs) as an exit market for venture-backed companies. These trends have accelerated in the current decade and are fueling burgeoning interest in new paradigms in venture capital that better align the interests of investors and fund managers and that provide the potential for outsized investment returns for which the asset class is known.

This paper will suggest that fund size segmentation yields important insight into the debate about the viability of the venture model and that smaller funds with less than $250 million of committed capital are the answer to better alignment and outsized returns. Additionally, given the recent global financial turmoil, there is a unique opportunity to acquire unfunded secondary interests in these smaller fund managers which further improves the return opportunity by lowering the cost basis and shortening the J-curve.

Finally, we believe that 2009-2019 will be a great time to invest in venture capital. The asset class has begun a painful process of rightsizing. We expect fundraising to decline by roughly 40% in 2009, and we estimate that nearly 50% of small fund managers will be unable to raise additional capital and will shut down over the next few years. Waning investor interest and the weeding out of underperforming managers is reducing competition and setting the stage for a powerful rebound in venture returns over the next decade, particularly at the smaller end of the market.

Evolution of Venture Capital Requires Fund Size Segmentation

The current debate as to whether the venture model is broken is flawed primarily because it erroneously presupposes that some standard investment model characterizes the venture asset class today. What is missing from the dialogue is a more granular understanding of how fund size drives investment strategy and is a key determinant of return potential. Venture capital, like all asset classes, is ultimately bound by the universal law of large numbers which dictates that outsized return potential diminishes with size. Segmentation by fund size was not particularly instructive or relevant 30 years ago when assets under management were more uniform across firms. However, as venture capital has institutionalized and matured over the last three decades, a discussion of segmentation can no longer be ignored. The public markets have witnessed the rise of micro-capitalization, small, mid and large capitalization investing. Leveraged buyout firms

© 2009 Industry Ventures, LLC

have staked claims to mega buyouts, mid-market and small company focused funds. These size distinctions indicate important elements of the investment strategy and the risk vs. reward profile.

The Rise of Large Funds

As seen in the table below, average venture fund sizes have more than tripled over the past three decades rising from $53.7 million in the 1980s to $179.7 million in the 2000s. In the 1980s nearly every venture fund raised was less than $250M, and only three $1 billion+ funds were raised. By contrast so far in the 2000s, 30 $1 billion+ have been raised. In the 1980s, small funds accounted for approximately 75% of all venture capital raised, and by contrast in the 2000s, small funds account for less than 33%.

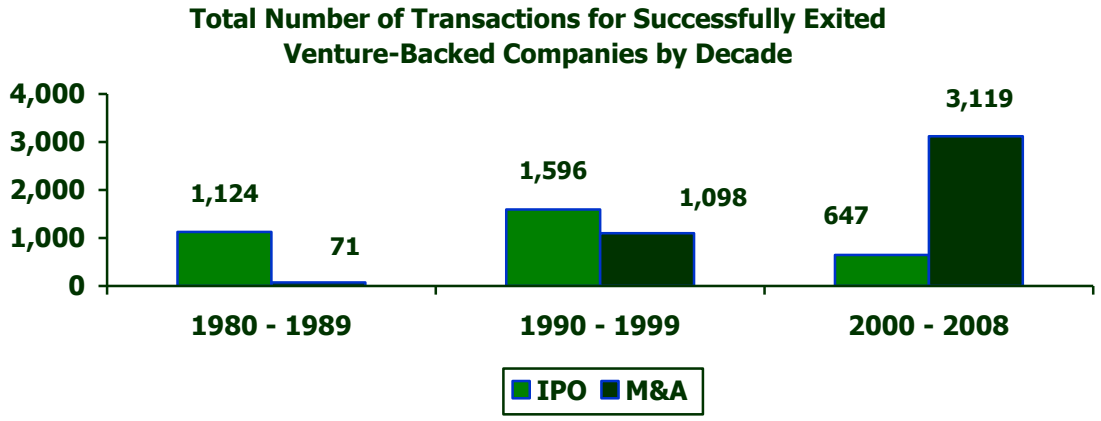
Time Period		Average Fund Size	Total # Funds	Total # Funds $250M+	Total # Funds $500M+	Total # Funds $1 billion+
1980s	$	53.7	653	12	6	3
1990s	$	94.7	1,344	147	47	15
2000s*	$	179.7	1,622	408	164	30
*Through 2008						

Source: Thomson Reuters (for funds greater than $10 million)

Declining IPO Markets for Venture-Backed Companies

As seen in the graph below, the sources of liquidity for venture backed companies have undergone a significant transition from the IPO market to M&A over the last three decades. In the 1980s, IPOs accounted for 94% of all successfully exited venture backed companies with only 6% occurring via M&A. By the 1990s, IPOs accounted for 59% of all successful exits with M&A a close second at 41%. In the 2000s thus far the trend has accelerated, and IPOs have accounted for only 17% of successful exits while M&A has accounted for 83%. Industry experts offer several reasons for this shift including: i) significant cost of compliance with Sarbanes Oxley and other requirements for public companies; ii) limited sell side research coverage from the banks; and iii) capital markets are requiring greater revenue scale and operating history for public companies.

© 2009 Industry Ventures, LLC



% IPO	94%	59%	17%
% M&A	6%	41%	83%

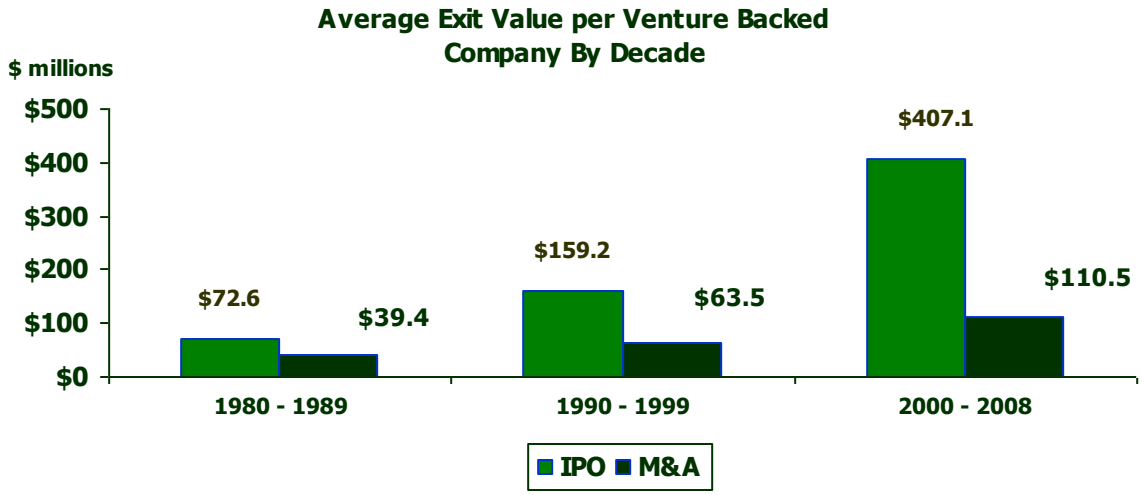
Source: Thomson Reuters

While the decline in IPO transactions for venture-backed companies in the 2000s is dramatic, the rise in M&A transactions has more than offset the losses such that there is a healthy trend line of positive exits over the three decades. Nevertheless, the implications for the venture market are clear: M&A is the most likely exit market for successful venture backed companies today.

Modest M&A Exits Are More Likely than IPOs

Venture backed companies have achieved consistently strong exits in each of the last three decades despite the shift in exit markets emphasis from IPOs to M&A. As seen in the chart below, both M&A and IPO markets have placed increasing valuations on successfully exited venture backed companies. Median M&A exit valuations have increased nearly 3x from $39.4 million in the 1980s to $110.5 million in the 2000s while median IPO valuations have risen over 5.5x from $72.6 million to $407.1 million during the same period.

© 2009 Industry Ventures, LLC



Source: Thomson Reuters

Despite this attractive increase in exit valuations over the last three decades, once again, the implications for today's venture industry are clear: M&A is the most likely exit market for successful companies and the average valuation is about $110 million.

Unfunded Secondary Market Opportunity

Though the secondary market has grown significantly in the last five years, very few firms focus on secondary interests that are less than 50% funded. Traditional secondary firms typically seek fully-funded secondaries, particularly for smaller venture capital and technology growth equity funds. Secondary investors focus on companies and the intrinsic value of existing assets which is fundamentally different than making an informed decision about a fund manager based on the team, strategy and track record. Because the paid-in capital is less than half of total committed capital for an unfunded secondary and the investment portfolio is only partially constructed, the investment decision and due diligence process for an unfunded secondary more closely resembles the primary commitment process.

Additionally, sellers of unfunded secondary interests are typically motivated by a desire to remove the remaining unfunded liability from their balance sheet. As a result, these sellers are often less concerned with the price to be paid for the paid-in capital (i.e. discount to net asset value). By contrast, sellers of fully-funded secondary interests usually have very little or zero unfunded liability.

© 2009 Industry Ventures, LLC

SOLUTIONS

Smaller Fund Business Model Well Positioned for Exit Environment

The case for smaller funds rests on the observation that M&A is the most likely exit and that average valuations will be around $110 million. Given the risk of early stage investing and venture capital's famously high mortality rate of portfolio companies, it is imperative that fund managers earn high return multiples at these more modest M&A exit values to offset casualties and drive attractive returns. The outsized return potential is then derived from one or two "homerun" investments that enable the fund to return multiples of total committed capital while the downside has been protected by more modest distributions from M&A or secondary sales.

The smaller fund business model is well-designed for success given these market dynamics. Specifically, smaller funds prioritize early-stage investments in companies with modest capital required to reach profitability where small amounts of capital garner significant ownership due to low entry valuations. Low entry prices enable small fund managers to achieve reasonable returns at exits even below $110 million and capital efficiency minimizes future dilution so that small funds can still have meaningful ownership at exit of their "homerun" investments.

A number of the most successful technology companies raised less than $10 million including eBay, Oracle, Cisco, Apple, Microsoft, Adobe, VMware and others (according to research from Altos Ventures). Ironically, business start-up costs have declined dramatically in the last 10 years due to advances in technology and communications while venture capital fund sizes have increased. This sometimes leads to tension between investors who want to put more capital to work while entrepreneurs want to minimize dilution and recognize that their businesses do not require substantial capital.

In contrast to smaller funds, larger funds prioritize investing more capital into each company in order to avoid an unmanageable number of portfolio companies. Since both large and small funds typically target 20 percent (or more) ownership, math tells us that larger funds must pay higher entry valuations or invest in companies that will require more capital. Additionally one homerun investment has a much more significant impact on a small fund. For example, a $100 million fund that owns 20% of a company which has a homerun exit of $500 million receives a $100 million distribution and returns the entire fund with one investment. A $1 billion fund that also owns 20% of the same company which exits for $500 million also receives $100 million but only returns 10% of its fund – less than the total amount of fees it charges its limited partners. Just to

© 2009 Industry Ventures, LLC

pay back committed capital to investors with 0% investment return, a $1 billion fund will need to have 10 "home run" exits of $500M each or at least 45 successful M&A exits at $110 million each assuming 20% ownership. This is a daunting task given the extremely high mortality rates of start-up companies.

Venture Capital Rebound: Rightsizing to Drive Outsized Returns 2009-2019

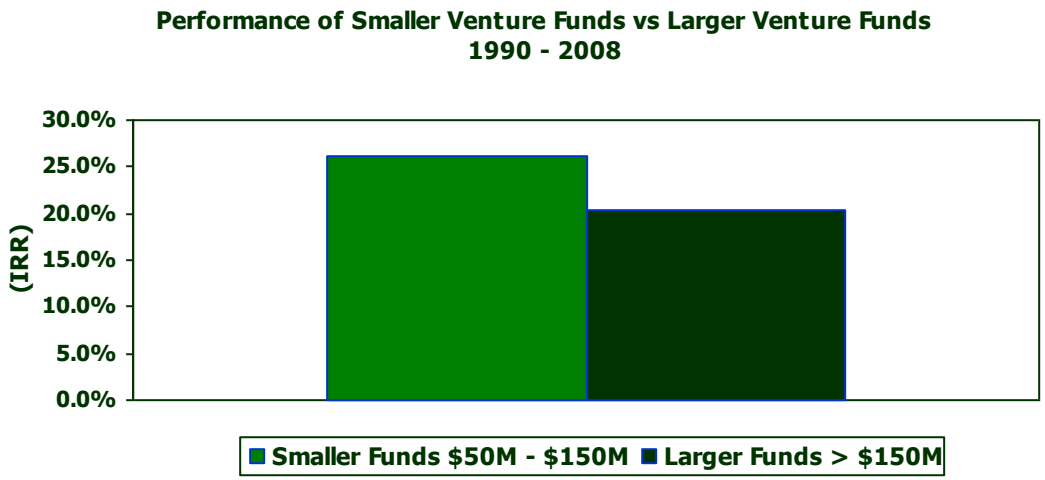
We believe the venture asset class will produce outsized returns over the next 5-10 years. Though rightsizing hasn't yet run its course, investors will need to make commitments in the next one to two years in order to have capital at work during the venture rebound given multi-year call downs. The principal driver of the venture rebound will be reduced competition—less capital and fewer managers—which will enable the survivors to achieve outsized returns over the next decade.

Specifically, we expect venture fundraising to decline by 40% in 2009 to about $17 billion from $28 billion in 2008. A number of institutional investors who entered the asset class this decade have become disenchanted and are abandoning venture capital as they have failed to achieve the spectacular returns of the 1990s. We project the small fund manager landscape to be dramatically altered by this reduction in fundraising. Roughly 1,200 venture capital funds of $250 million or less have been raised 2000-2008 which translates into about 600 firms managing smaller funds. We expect about ½, or 300 firms, to be unable to raise additional capital and to shut down over the next few years. Of the surviving 300 firms, we anticipate about ½, or 150 firms, will raise substantially larger funds and will sacrifice focus as a result. The remaining 150 smaller, specialized firms should then become the target universe for investors focusing on the smaller end of the market—top decile results will be achieved by selecting the best 15 managers from this universe of 150 smaller, specialized firms.

As seen in the following bar chart, smaller funds have outperformed historically by about 5.5 percentage points. However, we expect smaller funds to outperform by an even wider margin in the decade ahead owing to the dramatic reduction in competition. Those firms able to successfully raise capital will be able to drive better terms and lower valuations with their portfolio company investments. Furthermore these smaller, specialized funds will be appropriately sized to drive outsized returns from more modest M&A exits. However, should there be an improvement in the IPO market for venture-backed companies over the next decade

© 2009 Industry Ventures, LLC

that would be "gravy on top" for the smaller end of the venture capital market further improving an already compelling return opportunity.



Source: Cambridge Associates, LLC

Smaller Fund Alignment with Limited Partners

Smaller fund sizes produce lower management fee income and therefore managers have greater incentive to generate superior returns in order to achieve performance based incentive compensation. Furthermore, many smaller fund managers are in the middle of their professional careers and therefore have not yet accumulated the personal wealth equal to that of successful venture capitalists who founded firms two or three decades ago. Larger funds are generally managed by more established firms and are often perceived as "safer" investments; however, many of these established firms face challenges today due to several issues including:

- **Succession**: management transition from founding partners to the next generation of leadership;
- **Motivation**: significant personal wealth accumulation of senior partners may impact focus and effort level;
- **Compensation**: inconsistent compensation, management and investment responsibility across partnerships; and
- **Brand monetization**: emphasis on larger funds, international expansion and expansion into other sectors to increase assets under management.

Another often repeated criticism of smaller less well-known firms is that their deal flow is inferior to established firms. Not only is this comment inaccurate, but it also misses the

© 2009 Industry Ventures, LLC

fundamental point that the best entrepreneurs seek capital and guidance from individual venture capitalists and not from venture capital firms. Many highly sought after venture capitalists have been successful entrepreneurs themselves. These successful entrepreneurs-turned-venture-capitalists often prefer to establish their own firms in partnership with other like minded partners and decline to join established firms where they would have to adapt to a culture and a partnership which they played no role in creating. As a result, many of today's best entrepreneurs are by-passing meetings with junior partners of established firms and seeking capital and advice from successful entrepreneurs-turned-venture-capitalists at newer firms managing smaller funds.

Unfunded Secondary Limited Partner Positions

As a portfolio management tool, limited partners may seek to dollar cost average into their primary fund commitments through the purchase of unfunded secondary interests—thereby further improving the return opportunity by lowering the investment cost and shortening the J-curve. Additionally, taking the role of a willing buyer of an unfunded secondary, limited partners strengthen their relationship with portfolio fund managers. Sometimes, unfunded secondaries can also enable limited partners to access a fund which might have originally been missed as a primary commitment.

The table below illustrates the power of combining a primary commitment with an unfunded secondary to improve investment returns. In this example, Limited Partner A makes a $2 million primary commitment to a venture capital fund at inception. One year into the fund's life, Limited Partner A and all other limited partners have paid into the fund 20% of committed capital. At this point Limited Partner B, also with a $2 million primary commitment, is unable to meet the future capital call obligations for the remaining $1.6 million of unfunded commitment and decides to offer the interest for sale. Limited Partner A then agrees to assume this additional position from Limited Partner B and fund the remaining capital calls for consideration of $1. When the transfer is consummated, Limited Partner A accrues the benefit of Limited Partner B's capital account. Fast forward ten years when the fund is approaching the end of its life. If the fund has been successful in generating venture-type returns and achieves a 2.5x gross multiple on total committed capital, the limited partners as a group receive a 2.2x net multiple after the 20% carried interest has been applied. However, Limited Partner A's blended return of 2.4x is superior to those of other limited partners because of its transferred interest. Limited Partner A funded only $1.6 million in capital calls for Limited Partner B's $2.0 million commitment but Limited Partner A received the full $4.4 million net distributions owed to the Limited Partner B's

© 2009 Industry Ventures, LLC

$2 million original commitment. This secondary position returns a 2.75x net multiple to Limited Partner A, and when combined with the 2.2x net multiple on Limited Partner A's original $2 million commitment, Limited Partner A receives a blended net return of 2.4x surpassing the returns of other limited partners who did not participate in the unfunded secondary transaction.

	Primary	Unfunded Secondary	Total Position
Commitment	$ 2,000,000	$ 2,000,000	$ 4,000,000
% of Commitment due to Manager	100%	80%	90%
Capital Calls Paid	$ 2,000,000	$ 1,600,000	$ 3,600,000
Gross Fund Return Multiple	2.50x	2.50x	2.50x
Carried Interest %	20%	20%	20%
Net Distributions	$ 4,400,000	$ 4,400,000	$ 8,800,000
Net Multiple	**2.20x**	**2.75x**	**2.44x**

US VENTURE CAPITAL PERFORMANCE

Setting the Record Straight

Investment Performance

Performance of the venture capital asset class has been much maligned in the media over the last ten years. However, as seen in the chart below, venture capital has significantly outperformed the public markets in all time horizons and has significantly outperformed leveraged buyouts in every time horizon except the five-year time frame. While investors should never seek median returns in any asset class, the hard truth is that the pooled, net returns for the entire venture asset class have outperformed when compared to other investment opportunities.

Investment horizon performance through March 31, 2009

	1 Year	3 Year	5 Year	10 Year	20 Year
Venture Capital	**-17.5%**	**2.5%**	**5.7%**	**13.4%**	**17.2%**
Leveraged Buyouts	-26.4%	0.2%	6.7%	5.2%	9.3%
NASDAQ	-32.9%	-13.2%	-5.2%	-4.7%	6.8%
S&P 500	-38.1%	-13.1%	-4.8%	-3.0%	7.4%

Source: Thomson Reuters

© 2009 Industry Ventures, LLC

Distributions

For the skeptic who focuses only on cash-in and cash-out (ignoring the net asset value of unrealized investments since "you can't eat paper gains"), the following chart draws a similar conclusion. The venture capital asset class has distributed more capital than it has called in each time period except the one-year. Over the last 10 years, $135 billion has been called from investors and $152 billion has been returned resulting in $17 billion of excess distributions to investors. By contrast, the buyout asset class has never returned more capital than it has called in any time frame measured below.

Net Distributions: VC & Buyout as of December 31, 2008

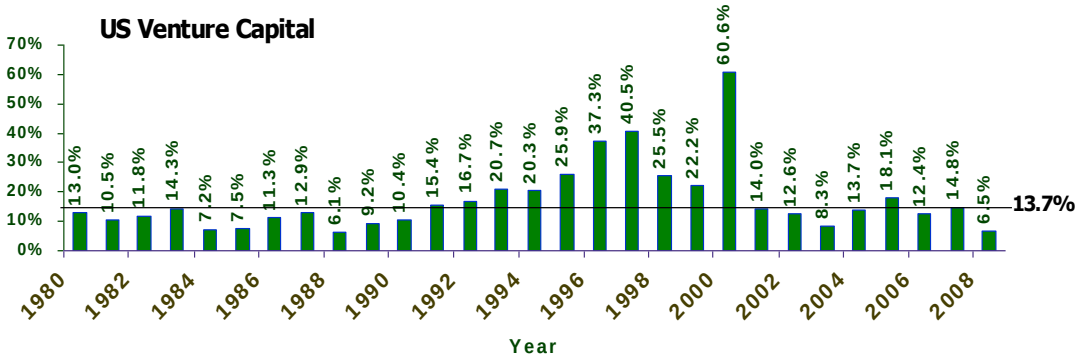
(in $ billions)	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**20 Year**
VC Cumulative Distributions	$5.3	$29.1	$53.2	$152.0	$206.1
VC Cumulative Calls	5.7	24.4	49.8	135.0	170.2
Net VC Distributions	**(0.4)**	**4.7**	**3.4**	**17.0**	**35.9**
Buyout Cumulative Distributions	16.3	107.8	205.5	306.0	394.8
Buyout Cumulative Calls	44.7	141.9	208.5	378.5	478.6
Net Buyout Distributions	**(28.4)**	**(34.1)**	**(3.0)**	**(72.5)**	**(83.8)**

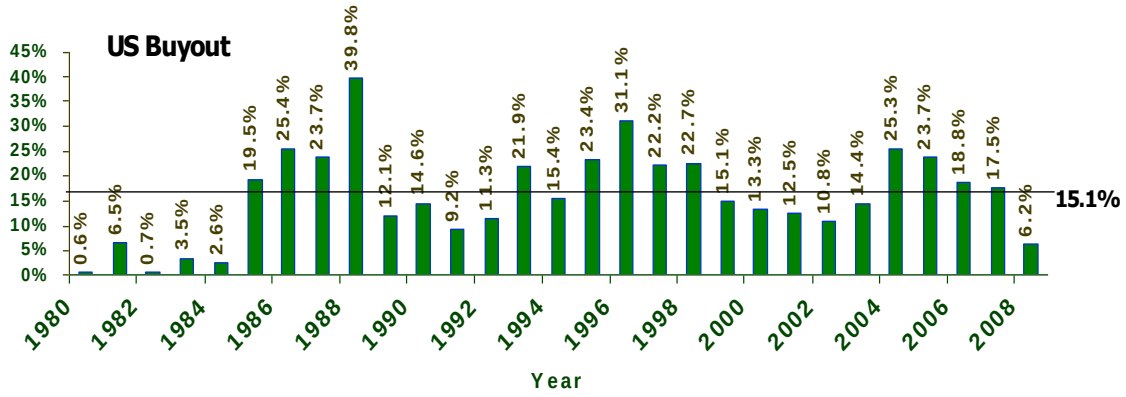
Source: Thomson Reuters

A further comparison in the graph below of distributions as a percentage of net asset value shows that venture capital distributions have averaged nearly 14% per year since 1980 which compares quite favorably to average annual buyout distributions of about 15% over the same period. Furthermore, despite popular opinion to the contrary, venture distributions in the 2000s have been consistent with the long-term average of nearly 14% of net asset value. Though buyouts have a slightly higher average annual distribution than venture capital, more buyout capital is invested in each year such that the absolute buyout distributions have not surpassed called capital in the time frames measured above.

© 2009 Industry Ventures, LLC

Distributions as a % of Net Asset Value





Source: Thomson Reuters

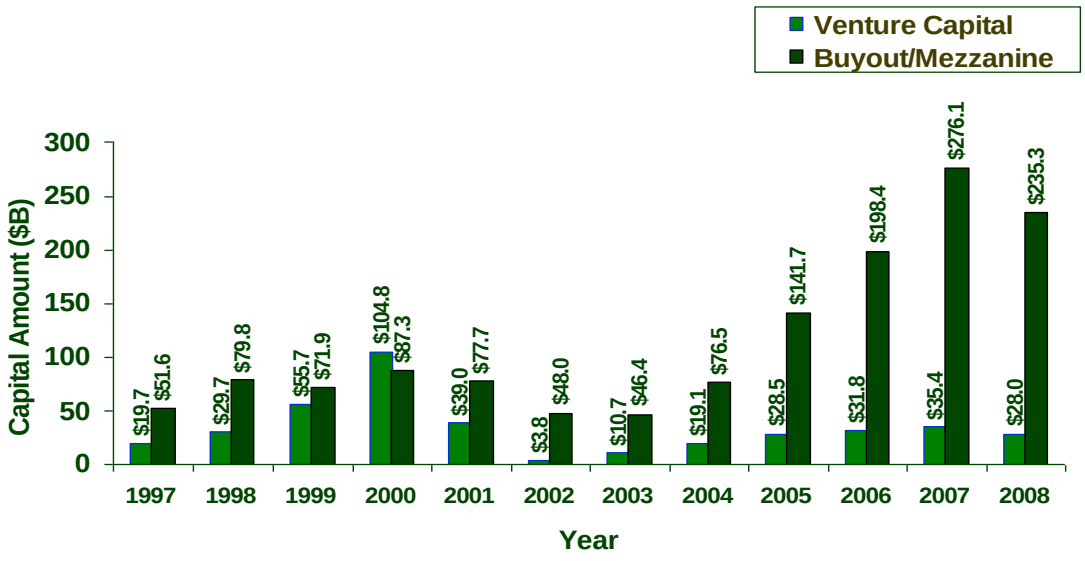
Fundraising

Similar to the misperception about venture capital performance, so too has the state of venture capital fundraising been unfairly maligned. The popular financial press often highlights record private equity capital raising in the last few years, but when private equity is deconstructed into its two principal components of buyouts and venture, there is a tale of two very different fundraising cycles. As seen in the table below, $28.0 billion was raised by venture capital firms in 2008, which is on par with 1998 funding levels, and significantly below the $104.8 billion raised in 2000. As previously noted, we expect a further decline in venture fundraising of nearly 40% to approximately $17 billion in 2009. This is in stark contrast to US buyout/mezzanine fundraising which set new records for three years in a row from 2005 through 2007. In 2008, US buyout/mezzanine fundraising reached $235.3 billion which was still more than 2.6x the $87.3

© 2009 Industry Ventures, LLC

billion raised in 2000. The record private equity fundraising in the last few years has been driven predominantly by record buyout fundraising.

US Private Equity Capital Raised 1997-2008



Source: Thomson Reuters

CONCLUSION

The decline in IPOs for venture backed companies and the significant increase in average fund sizes have dramatically altered the venture capital landscape. These trends have fueled speculation about whether the venture model is broken and have driven interest in new paradigms in venture capital that better align the interests of fund managers and investors and that provide the potential for outsized investment returns. However, little more than a focus on smaller funds is needed to cure these ills.

Looking ahead over the next decade, there is a compelling argument that the right-sizing of the venture capital asset class characterized by attrition of underperforming managers and reduced capital commitments is setting the stage for a venture capital rebound and for compelling returns in the ten years to come. We estimate that fundraising will decline by nearly 40% in 2009 and that as a result, about 50% of the smaller fund managers will be unable to raise capital and forced to exit the business over the next few years. Historically, smaller venture capital funds have outperformed, and the survivors of the current shakeout are likely to outperform by an even wider margin in the coming decade due to reduced competition. With an emphasis on small

© 2009 Industry Ventures, LLC

investments in capital efficient businesses with low entry valuations and high ownership, small funds can produce attractive returns from more modest sub $110 million M&A exits and generate outsized returns from one or two "homerun" exits which can return multiples of the fund's total committed capital.

These attractive returns can be improved by acquiring unfunded secondary interests which can lower investment cost and shorten the J-curve. Given the recent financial turmoil, there is increased availability of these unfunded secondary opportunities and few firms focus on such purchases. Additionally, smaller funds often have tighter alignment with investors owing to lower management fee revenue which increases the emphasis on generating performance incentive fees and the fact that smaller funds tend to be managed by smaller teams which are more focused on building a franchise than on monetizing their brand.

Ultimately, outsized return potential is driven by talented investors with differentiated strategies whose focus, relationships and expertise provides access to investment opportunities missed by others. Small venture capital funds, augmented by unfunded secondary purchases, offer one of the best opportunities to capture such outsized return potential in an asset class poised for a rebound over the next decade.

About Industry Ventures LLC

Industry Ventures is a leading investment firm that capitalizes on inefficiencies within venture capital and technology growth equity. The firm invests in both secondary and primary opportunities, including direct portfolios, secondary directs, limited partnership interests and other special situations. Headquartered in San Francisco, with offices in the Washington, D.C. area, the firm manages more than $450 million of institutional capital and has completed over 100 limited partnership and 90 direct investments. The Industry Ventures secondary team works with investors seeking near term-liquidity from existing direct and partnership investments. The Industry Ventures Partnership Holdings team focuses on secondary purchases of unfunded limited partnership interests and primary commitments to smaller venture capital and technology growth equity funds. For more information, please visit www.industryventures.com.

© 2009 Industry Ventures, LLC

Roland Reynolds, Principal

Roland leads the Industry Ventures Partnership Holdings team and focuses on unfunded secondaries and primary commitments to smaller venture capital and technology growth equity funds. Previously, Roland was the founder and managing partner of Little Hawk Capital Management LLC which was acquired by Industry Ventures in 2009.

Roland has 16 years of experience, including 10 years in venture capital. He spent five years as a Principal with Columbia Capital, a leading communications and information technology focused venture capital firm with $2.0 billion under management. Roland also spent four years in investment banking with JP Morgan & Co. in New York. He currently represents Industry Ventures on the Advisory Board of Kearny Venture Partners. Roland graduated from Princeton University with high honors and received his MBA from Harvard Business School.

Kenneth C. Wallace III, Vice President

Ken focuses on originating and valuing secondary and primary venture capital investments. Previously, Ken worked as an Associate Vice President in Bessemer Trust's Private Equity Funds Group in New York. In this role, he led the firm's venture capital fund investment strategy and due diligence process. Earlier in his career, Ken worked in Business Development with Bessemer Trust in its San Francisco, Menlo Park, Los Angeles and New York offices.

Ken earned a MBA from the Walter A. Haas School of Business at the University of California, Berkeley and a BA in Economics from Wake Forest University.

© 2009 Industry Ventures, LLC

CASE STUDY: FAIRHAVEN CAPITAL

The Fairhaven case study illuminates the outsized return potential of smaller funds in which one successful portfolio company can result in cash distributions in excess of the fund's total committed capital.

Fairhaven Capital Partners (or "Fairhaven"), headquartered in Cambridge, MA, is a complete spin out from Toronto Dominion Bank's venture capital group, formerly known as TD Capital Ventures. Industry Ventures Partnership Holdings is a limited partner in Fairhaven Capital Partners.

Top Quartile Performance

TD Capital Ventures' initial fund was closed in 2001 with Toronto Dominion Bank as the sole limited partner. As of March 31, 2008, this fund had invested $153 million and generated a 38% gross internal rate of return (26% net IRR since inception). Eight companies have been exited generating approximately $295 million in cash distributions and representing 2.5x investment cost. Top quartile performance for 2001 vintage funds according to Cambridge Associates is 9.4% (as of March 31, 2008); Fairhaven's same period results are nearly 3x better performance than the top quartile mark. Additionally, 12 active private companies remain in the portfolio which should result in additional distributions prior to the fund's expiration thereby further improving the strong investment returns.

TD Capital Ventures investment into EqualLogic, a storage networking appliance company, provides a clear illustration of the positive impact that one investment with outsized returns can have on the overall performance of a smaller fund. In March 2003, TD Capital Ventures made its initial investment into EqualLogic, and in November 2007, the company was sold to Dell Computer (Nasdaq: DELL) for $1.4 billion. EqualLogic is the largest all cash acquisition for a venture backed company, according to VentureSource, and the sale resulted in proceeds of $195 million to TD Capital Ventures for a 22x gross investment multiple on the fund's $8.9 million investment. The $195 million proceeds from EqualLogic alone returned 1.3x the entire TD Capital Ventures fund. As fund size increases, it becomes more difficult for one investment to dramatically impact overall fund returns.

© 2009 Industry Ventures, LLC