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*Alternative Investment Strategies*

PRIVATE EQUITY PARTNERS | MARKET UPDATE

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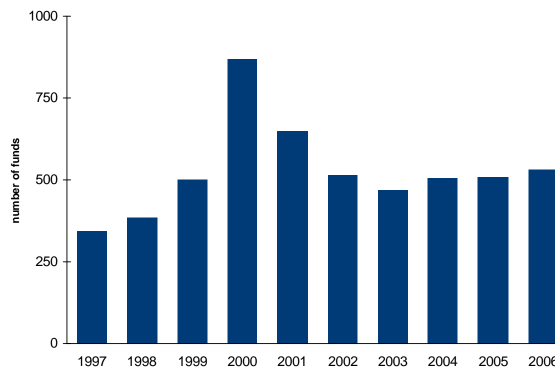
## Venture Capital: Bigger Funds, Fewer Firms

At the height of the 2000 bubble there were more than 850 active VC firms in the United States (defined as firms closing four or more deals in a calendar year). By 2003, that number dropped nearly 40% to less than 500. A severe market correction, lax investment standards from 1999 to 2000 and the subsequent scarcity of capital effectively forced less competitive and upstart firms out of business. This purge, in our view, was good for the health of the venture industry and is still ongoing.

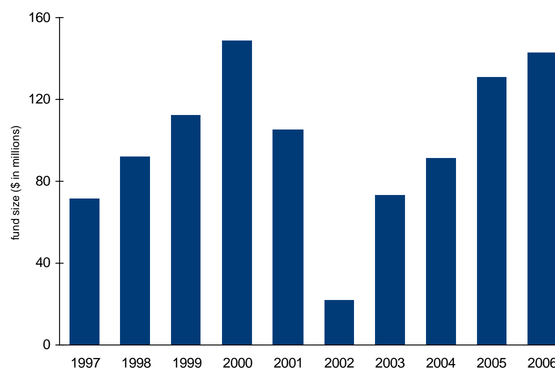
According to the National Venture Capital Association ("NVCA"), approximately half of VCs expect the number of active venture firms to decrease in the coming years. While some of this sentiment is based predominantly on wishful thinking for the "lesser competitive days gone by," there are significant reasons why the number of VC firms is likely to decrease over the next several years.

- Many bubble-era funds are in their seventh and eighth year of existence. They are struggling to return capital. Their limited partners have lost patience with them. They have been and will continue to be unable to raise a subsequent fund. They will fade into the background very quickly now that their investment period (or even an extended investment period) has ended and they no longer qualify as an "active" firm. Their partners will retire, find new roles at other existing VC firms, find jobs outside of the VC industry or attempt to launch a new VC firm. We wish this last group well since we believe the cards are stacked against emerging VC managers at the present time.
- Established managers who were able to weather the storm have raised new funds and are enjoying strong deal flow and increasing attention (and capital) from investors. Their fund sizes are generally increasing and many are keeping their early stage roots while using their bigger fund sizes to also invest at the later stage of the investment cycle. In fact, average fund size is at its highest level since 2000; a trend that three-quarters of the VCs surveyed by the NVCA say will continue into 2007.

**Number of Active VC Firms***




**Average VC Fund Size***

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- Several established managers (e.g., North Bridge, Sequoia, Redpoint and Draper Fisher Jurvetson) have recently raised funds that follow their historical early stage investment strategy, while also raising later stage funds. This has the effect of allowing them to keep the fund sizes small enough to effectively continue investing at the early stage, while using an affiliated vehicle to capitalize on later stage investment opportunities in their early stage portfolio and other late stage deal flow. These later stage vehicles also capture more capital and fee income from their investors. If this trend continues, investment capital would become further concentrated in the hands of experienced managers and they would crowd out upstarts in both the early and later stages.
- Growing fund sizes and robust economic conditions are compressing due diligence cycles. VC firms with less (1) experience, (2) due diligence capability or (3) industry expertise, are likely to be funding undeserving or “me too” companies in this competitive environment. For them, this will result in poor performance and ultimately their inability to raise future funds, further contracting the number of active firms.

### Conclusion

While a natural or cyclical expansion and contraction of the number of active investment firms is to be expected in the VC industry, we think we are in a period of contraction. We believe investors should be backing established managers who remember the painful lessons of the 2000 bubble and who are not resting on their laurels. While there are exceptions, **access to *energized* established managers**, not emerging managers, is still the general rule today.

** Source: Venture Economics as of 12/31/06.*

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## Private Equity Partners III Update

Fundraising for PEP III is rapidly progressing. ***The next closing is scheduled for April 6.*** We expect a final close in mid-summer. If you have not yet reserved your allocation, please contact Gretchen Postula at 612 303-6331 or gretchen.s.postula@pjc.com.

The underlying commitments for PEP III are well underway, with 80% of the fund committed or reserved for commitment with highly sought after, top tier LBO and VC fund managers. The most recent commitments include CarVal GVF, DFJ IX and Granite Global III. An allocation to TCV VII also was recently reserved. Underlying fund managers have begun putting capital to work, and PEP III has already drawn 15% of capital from existing investors.

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