

## viewpoint

# Nuclear winter abates in the New Year



PATRICK YAM

**“In the coming year, the VC industry will further evolve from its foundation as a cottage industry.”**

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**N**ext year will be earmarked by the uncertainties of a presidential election, as much as by evolutionary changes in the venture capital industry. The financial markets will remain enigmatic as they ponder global uncertainties and whether the current economic resurgence can be sustained. The captivated anxieties from a lack of investment during the “nuclear winter” may force optimism and heighten investment appeal, but will these sentiments be sustainable?

My prediction for 2004, published in a chronicle at Comdex earlier this year, stated that evolutionary change triggered by the dot-com era would be realized: “Venture capital will continue on an evolutionary path. Not unlike other industries, as the [VC] industry evolves, market segmentation of the constituent firms ... and distinction on a value-add basis [will gain] prominence. Spurred by the aggregation of capital between 1996 and 2001, the [VC] industry will now highlight the interdependent need of early-stage real ‘company builder VCs’ and later-stage more passive investors.”

In the coming year, the VC industry will further evolve from its foundation as a cottage industry.

More notably, 2004 will earmark the beginning of a new investment era as well as a contraction of the current universe of VC firms. More than half of today’s existing VC firms were established during the dot-com period. Despite the overhang of nearly \$75 billion in committed-yet-unsent venture capital and growing pressures from limited partners for the investment of subject funds, there are still many venture capital firms attempting to launch new funds. Many in the fund queue are dot-com era venture firms that will find the institutional community unforgiving for the poor investment returns of their venture portfolios. These firms will dissolve as a result of their inability to secure new funds.

The aftermath of this contraction will be a state of venture “haves” and “have-nots.” The “haves” will be constituted by larger legacy firms that will expand their assets under management. The old guard’s new funds will pale in comparison to the size of prior funds. Valuations for tech enterprises in 2004 will not appreciate markedly from today’s low assessments levels, encouraging investment. Legacy firms will still need to continue investing in later-stage rounds where the companies are mature, valuations are higher and they can invest larger sums. As a result, there will be a need for a new genre of VC firms that can invest in and provide company building support to earlier-stage tech enterprises. These firms will characteristically invest smaller initial sums while leveraging and employing their operational experience and skills to enhance the candidate’s probability of success. This distinction in investment philosophy along with the value add of complimentary skills will solidify the interdependency between company builders and legacy firms.

Fortunately, in 2004, venture capitalists will benefit from the greater likelihood that exit strategies can be successfully executed. There will continue to be limited initial public offerings (IPOs), but merger and acquisition activities will accelerate. The depressed Treasury yield curve will augment relatively low-cost borrowing and make acquisitions more affordable. Even if the curve rises toward a 10-year treasury yield of 5 percent (more likely in the first half of 2004 and not beyond as we prepare for the forthcoming presidential elections), acquisitions will be prevalent. High cash levels on the balance sheet of many public technology enterprises along with their surging share prices will further support acquisitions. Private companies will join in the acquisition fray.

Information technology budgets will rebound, but not to the mass spending levels we evidenced prior to the millennium. Budget dollars will primarily support consolidating and simplifying existing infrastructures and bringing new efficiencies to IT for 2004 and beyond. Wi-Fi and wireless data technologies will remain a favorite investment of many VCs.

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