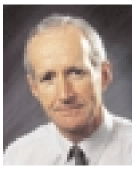
A HEALTHY DOSE OF REALITY



THE PAST 18 MONTHS HAS SEEN A DRAMATIC TRANSFORMATION IN THE HIGH TECHNOLOGY MARKET. BUT IT IS NOT ALL DOOM AND GLOOM, AS **PAUL CASTLE** OF MTI PARTNERS EXPLAINS.

Since the first half of 2000 the environment for early stage high technology venture capital has changed out of all recognition. Similarly, the quoted technology sector has also experienced dramatic transformation. Over the 18 months from early March 2000 the FTSE TechMark index of the London Stock Exchange has fallen by about 80%.

A galaxy of former stars of the quoted high tech sector have acquired the dubious distinction of becoming members of the 90% club, whereby their share prices have fallen by more than 90% since their highs last year – and some have even succumbed to the 99% club. Droves of thrusting, aggressive, exciting dot.com and e-commerce companies have disappeared without trace within the space of 18 months, as have a majority of the internet incubator funds that so enthusiastically provided millions and millions of pounds to feed prodigious and never-ending appetites for consuming cash. Net asset values and share prices of more mature dedicated technology funds have been decimated in sympathy.

A MODEL FOR THE NEW ECONOMY. A high tech venture capital investment is a combination of a business concept and equity capital to enable a business model to be set up that captures a substantial future commercial opportunity and whose valuation will be recognised and crystallised mid-execution by a trade sale or IPO. Regrettably, at the start of the new millennium, a brave but foolhardy new economy venture capital model spread like wild fire whereby a couple of bright young things from the media/marketing/PR stable dreamt up out of thin air an idea for offering a conventional service over the internet. They approached via an investment forum a clutch of incubator fund managers eager to put money to work, and thereby secured seed funding on the basis of a nebulous conceptual 'plan'. A team of software junkies and sexy website designers were then acquired, and a portal developed and published with much publicity and even more expenditure. However, revenues failed to materialise and further injections of funding were required.

At this juncture the problems started. The incubator fund manager was unable to provide the new funding, either because his own fund had been fully invested or because the additional investment in an existing investee company would have unduly increased the proportion of the fund allocated to one company. Therefore, the investee company approached the established (old economy) providers of venture capital, only to be faced with the response from that quarter that the insubstantial and ill thought through business proposition was one of hundreds that were reviewed regularly and did not merit serious consideration. The resulting failure was a disaster not only for the underlying investee company but also for the incubator fund that made the initial investment. As a result, a large proportion of the portfolios of all the incubator funds rapidly exhibited serious losses, and most of such incubator funds disappeared without trace as quickly as they had appeared. Those that have survived have radically changed their business models, either to revert to the conventional venture capital fund manager model or to operate in an advisory capacity, rather than as a principal.

One of the unfortunate side-effects of this phenomenon was that genuine technology investments were grouped together with the dot.coms and e-commerce businesses and by association suffered from the same reputation. The media is guilty of branding the dot.coms and e-commerce businesses as existing in the technology sector, and telecommunications, media, technology (TMT) unfortunately groups together in one catch-all definition worthless dot.com and e-commerce basket-cases with first-class world leading technology companies. However, enabling and exploitative technologies that underpin and expand the mode of use of the internet offer outstanding investment opportunities to the genuine venture capitalist.

With the demise of the short-lived new economy frenzy, of the dot.com and e-business fraternity, and of the incubators, the traditional and proven old economy model of venture capital has been restored to its rightful place as the tried-and-tested approach. The process involves the investment of sweat equity by the investee company's founding management to develop a pre-production prototype of the hardware or software product which is used in conjunction with a business plan, to raise the preliminary start-up round of funding. Using this finance the company would launch a product, initiate sales and marketing and embark on first production revenues in preparation for a further round of venture capital funding. In the next expansion phase, revenue growth and profitability would be achieved to support a pre-exit round of funding in preparation for a trade sale or an IPO.

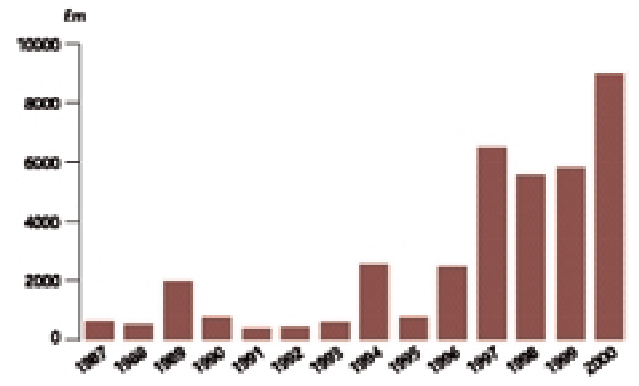
SELECTING THE BEST. Faced with the experiences of the past couple of years, it might be thought that the prospect for young, early stage hi-tech companies to raise equity finance is non-existent for the foreseeable future. But nothing could be further from the truth. The only effect the downturn in the quoted technology sector and the elimination of the absurd over-hyped dot.com and e-commerce frenzy has had on the fund raising prospects for early stage technology companies is the injection of a strong dose of reality and common sense. In fact, there are substantial amounts of cash available to invest. For example, MTI, Advent Venture Partners and Amadeus, the UK's leading early stage technology venture capital fund managers, each raised nine-figure sterling funds during 2000, while Apax, the leading generalist private equity firm, announced the successful raising of a monster €4bn fund, of which much will be dedicated to early stage and technology situations. Together these fund managers and others like them have the desire and capacity to invest in early stage technology companies in amounts ranging from a few hundred thousand pounds to several tens of millions.

But these venture capital fund managers are seasoned professionals, having operated in the technology sector with conspicuous success over very many years, generating consistently good returns for their investors. While they have huge amounts of money at their disposal for investment, they nonetheless are very selective and will only contemplate investment in what they perceive to be the very best opportunities. Also, in the current climate, while they will not be deterred from investing, they will nevertheless use the opportunity to conclude deals that are priced at the bottom end of investee company expectations. It is likely therefore that the amounts invested in early stage technology deals, and in private equity transactions in general, will experience a decline in 2001 relative to the record sums invested in 2000.

Similarly, the amounts raised by venture capital fund managers from their institutional investors is also likely to have declined in 2001 compared with the record achieved in 2000, when £9bn was raised by UK-based independent fund managers.

A CYCLICAL PATTERN. *Figure 1* shows the funds raised for UK independent venture capital fund managers over a 14-year period, and demonstrates that, like all other forms of economic activity, the amounts raised follow a cyclical pattern – albeit within the context of a progressively rising trend. The figures for 2001 will almost certainly signal the start of the next downward phase of the cycle, reflecting the general bearish conditions that have prevailed for the past 18 months, and the specific material deterioration in the TMT sector. But it must be remembered that venture capital is a medium- to long-term business and that in the early stage technology sector the typical life-cycle of an investment from completing the initial deal to concluding a successful exit will range from three to seven years. High tech venture capital funds with a life of 10 years – which take say, three to four years to become fully invested – will experience the effects of one, if not two, further economic cycles during their lifetime, during which the fortunes of their investee companies will ebb and flow, all the while generating respectable returns for their investors.

FIGURE 1
FUNDS FOR UK INDEPENDENT VENTURE CAPITAL, 1987-2000.



Source: BVCA

'THESE VENTURE CAPITAL FUND MANAGERS ARE SEASONED PROFESSIONALS GENERATING CONSISTENTLY GOOD RETURNS FOR THEIR INVESTORS'

ENCOURAGING SIGNS. Over the past three years the British Venture Capital Association's Investor Relations Committee has worked with the NAPF and the ABI to promote among their respective memberships the benefits and superior returns to be obtained from allocating a proportion of their assets to private equity and venture capital. In addition, the Myners Report supported the proposition that an asset allocation to private equity was to be encouraged. Accordingly, the UK's private equity industry could have reasonably expected that the amount invested and the number of institutions participating in the asset class would increase as a result of such initiatives. Whether or not this will be the case in the short-term following the collapse of the technology sector and the decline in the world economic conditions is open to question. It is particularly unfortunate that the momentum that was building in favour of increasing new allocations to the British venture capital industry may now be set back by a number of years.

For all these reasons, in my view the UK high tech venture capital industry will remain strong and active. As a result, the venture capital fund, and therefore its investors, benefit from a virtuous cycle of events whereby attractively priced new investments can look forward to an improving economic environment, aggressive growth rates, bull phases of stock markets, receptive conditions for exits on favourable ratings and thus very attractive returns. In short, the time has never been better for making increased or new commitments to high tech venture capital.

Dr Paul Castle is Chief Executive, MTI Partners. He is also a member of British Venture Capital Association's Investor Relations Committee.
pcastle@mtifirms.com
www.mtifirms.com