

Crisis in Venture Capital Creating Historic Opportunities: A View from New York

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There is a global crisis in the venture capital industry, which is hitting particularly hard in the U.S., affecting emerging technology and healthcare companies across the board. Venture funds are gradually running out of capital, with limited means in the current capital markets to replenish with new funds. The problem is compounded by regulatory trends in the past few years which have effectively closed the IPO market for their portfolio companies.

In the capital drought, many companies with exciting technologies are turning to strategic capital and M&A. This represents an historic opportunity for Chinese investors, particularly those seeking channels to put dollars to work. Roberts Mitani has been structuring innovative cross-border transactions between US companies and Asian partners, including Japanese and Korean companies, since its founding in 1992. We work often in the life sciences, clean technology and consumer fields, but the techniques we have developed apply in many sectors. Based on our experience in this market, we would like to share several key observations on structuring successful deals in the current challenging environment.

The Simmering Crisis

According to the Wall Street Journal, only 134 out of 435 funds raising capital in 2009 had completed funding and closed to investors as of early November, compared to full-year totals of 309 out of 452, and 363 out of 445 funds, in 2008 and 2007, respectively. New funds have aggregated \$20.4 billion, a 65% reduction from the \$58.2 billion raised in 2008.

The study further indicates that the decline in investor interest in venture capital may be long term, rather than the consequence of a temporary cyclical economic downturn. Many institutional limited partner investors are discontinuing their venture capital allocations or demanding major fee concessions due to a decade of disappointing returns. While the average return for venture capital funds was 34% for the decade ending June 30, 2008, the number is deceptive since much of the return was generated in early 1999, before the burst of the technology bubble. When this period is removed, the average return drops to 14%.

The decline in returns cannot be blamed on the venture capital industry alone, although many saw too many funds with high overheads chasing a limited number of deals. The problem arguably was compounded by errors in regulatory policy in the

U.S. They are cautionary lessons on the limits of regulation to correct the clear problems manifested in the global financial markets by the Wall Street meltdown.

The first misstep was the extension of heightened financial reporting requirements to emerging companies under the Sarbanes Oxley Act ("Sox"), passed by the U.S. Congress in the wake of the Enron scandal. These requirements significantly increased accounting costs for venture-backed start-ups seeking to go public and cooled the IPO prospects for a number of these companies. While the government has subsequently sought to alleviate deleterious effects of this legislation on smaller issuers, the chill has remained, limiting access to the public markets for these companies and liquidity for their VC backers.

The second error was the settlement among Wall Street underwriters brokered by then New York State attorney general Elliot Spitzer, widely hailed as innovative and forward-thinking at the time. This settlement addressed concerns about conflicts of interest and misstatements in sell-side research being put out by Wall Street firms, by seeking to separate the research departments entirely from the banking activities of these firms. An admirable goal, but under the law of unintended consequences, the result arguably has been to eliminate meaningful research coverage of many worthy emerging companies, further closing off access to the capital markets to them and their investors.

The net result of these unintended consequences amounts to a serious threat to an historic U.S. competitive advantage – the country's unique ability to foster and nurture new ventures via a dynamic venture capital sector and assure their growth by direct access to a vast and accessible public capital market. The goal of regulation to address certain systemic abuses was reasonable. However, when these abuses are judged against the actual systemic risks that nearly took down the economy, the reforms arguably were equivalent to using artillery to shoot fleas off of elephants.

In the meantime, American venture companies are waking up to the fact that their investors are slowly running out of money and are scanning the horizon to find safe ports where they can fund future growth.

The Opportunities to Create Value



Bruce Roberts (left) and Hideki Mitani (center) with a colleague at their Manhattan offices

Increasingly, these companies are seeking strategic partners, which creates a significant opportunity for Chinese and other Asian investors. In the past, the managements of these companies would be reluctant to license significant regional rights to their products or technologies, particularly in the biomedical field, since their venture backers preferred to keep the rights intact for an exit to a multinational company. With multinational corporate buyers also proceeding cautiously, venture companies are far more open to this option and appreciate the importance of gaining access to customers in Asia. When this change in attitude is combined with other factors, such as the competitive valuations of private companies and the exchange rate of the dollar, the result is an historic opportunity for investors in Asia to participate in the innovation economy in the US, which continues to generate exciting new products and ideas.

Based on my firm's experience as advisors to Asian investors as well as US venture companies, we would recommend the following steps to new investors:

- Look systematically for opportunities: If you are a corporate player, or a pure financial investor, we encourage you to invest based on a clearly defined set of priorities rather than ad hoc. Then, seek to identify the opportunities

fitting your criteria by a systematic outreach to the companies or venture capital firms who are active in these sectors. We would anticipate that your audience will be quite responsive.

- Don't be afraid to take a lead role: Once you identify a company in which you want to invest, you may find that the management

would like you to be a "lead" investor, who negotiates the term sheet and sets the price for all investors in the financing. Don't be surprised if the current venture capital investors in the company are ready to invest along side you on the terms you propose. Historically, the lead role was played by a new venture capital investor, but as these investors become scarce, a new strategic or institutional investor from overseas is equally welcome. If you wait for another lead investor to step up, you may miss an opportunity.

- Invest in the company, not in the license: If you are a strategic investor seeking rights to a company's products for a market such as China, you may be inclined to invest only as much as is needed to secure such regional rights, with the company retaining a right to buy out such regional rights in the event of an M&A. Often, the strategic investor holds only minority interest in the company; perhaps as low as 5% or 10%. We would encourage such strategic investors to think more ambitiously. If the company is successful, then they may sell to a multinational and buy you out, without you enjoying the chance to profit on sale of the products in your market. If you negotiate a deal where you are a true partner, holding as much as 40 to 50% of the equity, you will have more options and upside in the event of an M&A opportunity. Alternatively, consider acquiring a controlling interest from the start.

- Invest for the long term: Last but not least, one must avoid the shortsightedness which left many of these venture companies in their current straits. Too often, the capital structures of these companies have misaligned interests of investors and management. New investors may have the chance to restructure these companies with a clean slate, and in the process contribute to a new paradigm of global innovation.