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MACROCOSM

Nothing Ventured

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With VC funding and IPOs still depressed, the growth engine is likely to sputter.

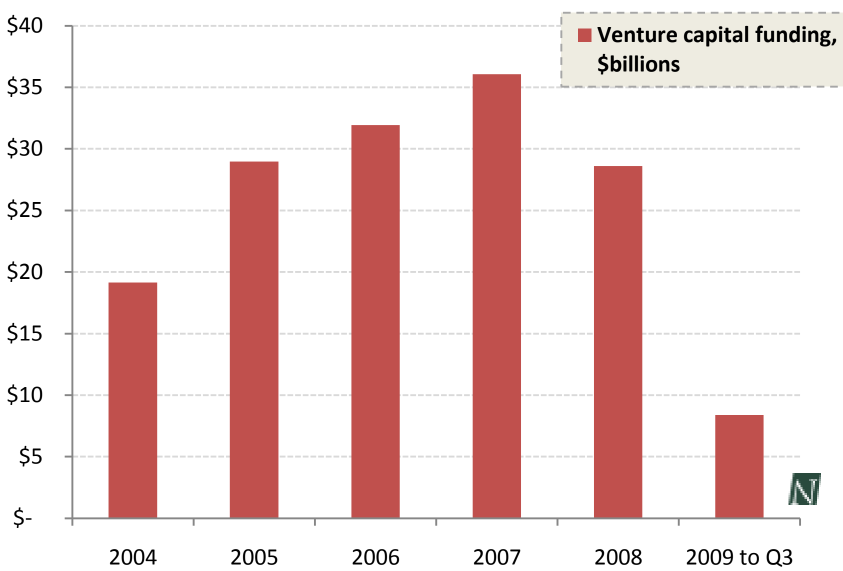
Update to strategic view

US MACRO: As the credit crisis ebbs in larger markets, risk aversion remains high in the critical venture capital space. VC-backed start-ups are a vital engine of job creation and output growth, so the shortfall in new funding and IPOs confirms the likely sluggishness of recovery from recession.

[see Investment Strategy Dashboard]

While we have observed and been highly encouraged by the restoration of risk appetite seen across a wide variety of market segments, one critical sector continues to be distressed by a paralysis of risk aversion. Venture capital funding in the third quarter was down more than 80% from a year ago, while just three venture-backed firms were able to access the public equity markets with initial public offerings.

Venture capital provides vital support for the entrepreneurship and innovation which drives economic growth. Some 20% of GDP is directly produced by companies that were created by venture capital, and the competitive catalyst that comes with the innovative startups produced with venture funding contributes to expansion in ways that go well beyond that. Absent a healthy and vibrant venture capital market, the outlook for growth has to be considered sub-optimal (see "Muted Celebration" September 3, 2009).



The large institutions that provide the backing for VC firms -- university endowments, pension funds, charitable foundations and the like -- are still licking their wounds, having absorbed huge losses in the crisis. Princeton University lost nearly 24%, Harvard 27%, and Yale 25% in the past year. With its endowment down 27% from a year ago, Stanford recently announced it is planning to liquidate $1 billion of

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its $12.6 billion portfolio, including venture capital. For these investors, funneling fresh capital into tiny, highly risky startups isn't the order of the day. So through the first three quarters of this year, VCs raised only $8.3 billion, compared to $25 billion in the comparable period last year and $28.6 billion for the year as a whole, and $36 billion in 2007.

Moreover, the IPO exit for VC-funded firms has basically shut down, effectively stretching the expected duration of any capital commitment. Through the first three quarters, eight venture-backed firms went public, raising just less than $1.3 billion, at best a Pyrrhic improvement over the six IPOs last year that raised just $470 million. In 2007, 86 IPOs raised $10.3 billion. The overall IPO market is also down this year, with 36 new listings, about a tenth of the total seen in 2007. But the companies that are coming public are almost all profitable, established firms, not the kind of start-ups usually backed by VCs. The virtual blackout of IPOs for risky enterprises indicates that the most growth-critical risk capital remains sidelined despite the progress apparent in other asset classes.

One consequence of the dearth of VC activity is a paucity of the startups that usually contribute significantly to job growth. By one estimate, firms with less than 50 employees -- few venture-backed start-ups are bigger -- have accounted for about one third of job growth since 1992. The stall in venture capital has to be considered a significant factor in the continuing stagnation of the labor market, in which the problem is not job losses as much as it is the failure of new jobs to be created (see "On the July Jobs Report" September 4, 2009).

Policy uncertainties are also a burden in the venture capitalist's world. Versions of the so-called health care "reform" legislation now being considered in Congress would mandate that small businesses provide insurance coverage to their employees, boosting their costs, hurting their competiveness and penalizing compensation. Also, in the Treasury Department's financial regulatory reform proposal under discussion on Capitol Hill, VCs would be subject to registration requirements, requiring they provide data to enable determination of their potential "systemic risk," implying costly compliance burdens. Why VCs would ever be considered potentially "systemic" is a mystery. They don't carry debt and don't trade in public securities markets. The idea seems borne of a general distrust of risk-taking coming out of the near calamity of the credit crisis. If that's the case, it is a disturbing portent. Representative Barney Frank (D-MA) has exempted VCs in the House version of the legislation, but they remain covered in the Senate bill. The future robustness of the venture business could hinge on the outcome -- and so could growth.

BOTTOM LINE: As the credit crisis ebbs in larger markets, risk aversion remains high in the critical venture capital space. VC-backed start-ups are a vital engine of job creation and output growth, so the shortfall in new funding and IPOs confirms the likely sluggishness of recovery from recession.