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SMALL BUSINESS

The Return of the Venture Capitalists

By ANNE FIELD

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In the world of venture capital, it may not be the best of times. But it is sure not the worst, either.

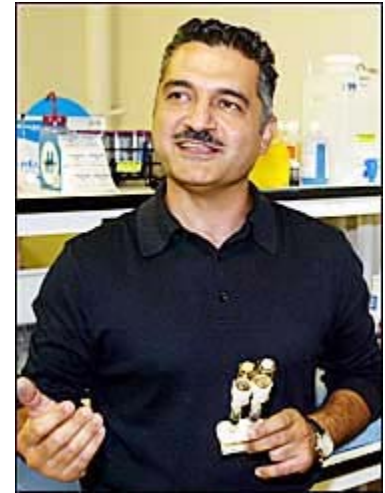
Four years after the Internet bubble burst, the venture-capital industry is stirring back to life. Investments by venture firms rose 22 percent in the second quarter of this year, to \$5.8 billion, from \$4.7 billion a year earlier, according to the MoneyTree Survey by PricewaterhouseCoopers, Thomson Venture Economics and the National Venture Capital Association.

For all of 2004, analysts project an 11 percent increase in investments, to \$20 billion, from \$18 billion in 2003.

That is a far cry from the \$108 billion in the heady days of 1999, and nobody in the venture-capital business is predicting a return to that flood of cash. Rather, "it's as though the turtle got out of its shell, looked around, and decided it was safe to go out," said Jesse Reyes, vice president for global research for Thomson Venture Economics in New York City.

Venture capitalists cite several factors for the improving situation, starting with the reviving economy. Forecasts of increased technology spending by corporations are also fueling the uptick, they say. Then, there is the simple matter of time. After spending several post-bubble years licking their wounds and propping up existing companies in their portfolios, venture capitalists are finally looking around for new investment opportunities.

As for entrepreneurs, many more are now willing to come forward with innovative ideas than during the years immediately after the Internet debacle. "Before,



Randi Lynn Beach for The New York Times
Fred Khosravi has founded two companies in two years. He found it easier to acquire venture capital funds the second time. He has benefited from being in life-science ventures, a popular area among investors.

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entrepreneurs were hunkered down, unwilling to take a risk in such a terrible environment," said Geoff Yang, a partner in Redpoint Ventures in Menlo Park, Calif. "But, now, they're coming out of hiding."

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Mr. Yang and other venture capitalists report significant increases in the number of deals they are looking at these days, especially in start-ups. He estimates that the number of investments his firm is considering is up 40 percent to 50 percent from a few years ago.

The competition among venture capitalists to get their foot in the door of promising companies has also heated up. The time that elapses for a deal to close has been cut by more than half, from six to eight months two years ago to two or three months today, said Bill Ericson, a general partner with Mohr, Davidow Ventures, another Menlo Park firm.

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Perhaps the most encouraging development for entrepreneurs is the increase in venture-capital investments in early-stage companies, to 231 in the second quarter of 2004, the highest number in two years, and up from 207 a year earlier, according to Venture Economics.

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These deals accounted for 30 percent of all venture-capital investments, the highest proportion in more than three years, while the average capital infusion per company rose to \$4.9 million, up from an average of \$4.6 million over the previous four quarters. What is more, seed funds - money invested in start-ups, which venture capitalists shunned after the bubble burst - accounted for 32 percent of all deals in the second quarter of this year, up from 29 percent for all of 2003, said John Gabbert, vice president for worldwide research at VentureOne, a market research firm in San Francisco.

Some firms have decided it is time to plunge into a suddenly promising market. Mark Hilderbrand, a general partner in Onset Ventures in Menlo Park, which focuses on early-stage companies, says it expects to make as many as 10 investments this year, up from just one last year.

Such renewed enthusiasm has been good news for entrepreneurs like Fred Khosravi. Two years ago, Mr. Khosravi founded a company called Access Closure in Mountain View, Calif., to develop and sell a technology to improve angioplasty procedures. He had a tough time finding takers, although in late 2002 he managed to raise \$3.5 million from Onset and a group of private investors willing to invest in what was then a relatively unpopular area. A year later, he raised \$10 million more from a group that included Three Arch Partners and Onset.

Late last year, Mr. Khosravi helped found another company, Sadra Medical in Cupertino, Calif., to develop a technology for the replacement of aortic valves. A few months later, it easily raised \$9 million from Onset, as well as from Pequot Capital Management and Schroder Ventures, despite the fact that the company was at an earlier stage of testing than was Access when it received its first round of financing. Mr. Khosravi said he was also able to negotiate a similar valuation to the one he got at Access, even though the newer company had reached a point considerably less proven, and riskier, in its product development.

Mr. Khosravi is benefiting from being in the hot life-science sector, which includes biotechnology and medical device companies. About 25 percent of all venture capital is going to that area these days, according to the MoneyTree survey, in large part a result of declining investor interest in Internet and telecommunications companies. "You have to put your money somewhere," said Mark Heesen, president of the National Venture

Capital Association in Arlington, Va.

At the same time, it is unlikely that start-ups will see a return to easy-money days anytime soon, in part because many firms are not raising the kind of funds they did during the bubble. While venture capitalists are stepping up their own fund-raising efforts, raising \$5.8 billion in 82 funds in the first half of this year, almost double the \$3 billion they raised in 76 funds in the 2003 period, according to Venture Economics, the amount of money available from each fund may be less than was the case several years ago. Back then, many of the bigger funds had close to \$1 billion or more.

Some firms started scaling back fund size around 2001, when they returned significant portions to their investors. Mohr, Davidow reduced its \$850 million fund by almost half, Mr. Ericson said. Redpoint gave back about 40 percent of its \$750 million fund in 2001, Mr. Yang said. The firm is not currently raising a new fund, but, when it does, he expects it to be "substantially smaller" than before.

The key to winning some of that money, according to venture capitalists, lies in the acumen of company management. That has always been true, of course, but according to investors, it is even more of a factor now. Robert E. Brown Jr., managing general partner of Meridian Venture Partners in Radnor, Pa., said: "People are so much more sophisticated these days about how to make their case. Everybody can walk the walk and talk the talk."

The real test, then, is whether company management has already proved its mettle with appropriate industry and small-company experience. "Even if they were unsuccessful, at least we know they tried and learned from what they did before," Mr. Brown said. Recently, he said, the firm added a psychological test to the last step of the decision-making process "to sort out the wheat from the chaff."

One way for entrepreneurs to improve their chances of getting money from venture capitalists is to solicit their advice first. Two years ago, Jack Danahy, the founder of Qiave Technologies, a company that makes a software security product, and two partners decided to start a second software company. But instead of trying to develop an idea on their own, they spent three months picking the brains of venture capitalists at Greylock, a Boston venture-capital firm, and Commonwealth Capital Ventures in Wellesley, Mass., as well as clients of both firms, asking their advice on market opportunities.

Based on those conversations, they started Ounce Labs in Waltham, Mass., another software security company, and raised \$3 million apiece from the two venture capital firms early this year. "The negotiations went very smoothly," Mr. Danahy said.

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