

# Visionaries

~ The YVCS Newsletter ~

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*The Young Venture Capital Society would like to take this opportunity to thank its advisory board for their help and support. A significant amount of work is needed to produce the events and products of the YVCS and it would not be possible without their assistance.*

## HELLO 2005

## GOOD BY Q1—WE HARDLY KNEW YA

### SINS OF THE TECHNOLOGY BUBBLE

By Patrick Michel

The market crash of the late 90's has crystallized a tried and true economic principle. When too much money purses too few deals investing principles suffer. In hindsight, many venture capital investments were doomed from the very start and the aid of a bit scrutiny would certainly have weeded out deals which become painful investing lessons.

“Cash is King”

The most striking phenomenon of the technology crash has to have been the tremendous cash infusions which were spent with little or no accountability. Ironically, this spending philosophy may have been the product of the very VCs funding technology companies. VC funds are under tremendous pressure to drawdown on their capital commitments and fully invest their funds prior to raising the next fund. Limited Partners have highlighted this desire to raise new funds as a significant factor in underperforming portfolios which developed in the tech boom.

In the context of a VC company, portfolio companies were encouraged to spend as much capital as possible in order to increase value and raise the next round of funding. The measure of value was curious at best in many cases but nevertheless, new investors poured money into companies with increasing cash burn rates and long horizons to profitability and becoming cash flow positive. One of the underlying assumptions, given the long economic prosperity, was that additional funding would always be available to allow young companies to reach profitability. (See below “The Economic Cycle”)

The general defense by VCs at the time was that market share and being “first to market” were the priority. Portfolio companies had to spend to achieve these objectives without being forced to determine the most basic of principles: return on investment. An extreme example of this type of spending was the spending for “launch parties”, “company parties” and numerous one time promotional events. Millions were spent on lavish office spaces, entertainment, food, and assorted perks.

In their defense, it is the very lack of long history which makes its difficult for a portfolio company to determine the success of any marketing and promotion strategy. However, this inexperience was exacerbated by young CEOs, belief in the “new” business model (if you build it they will come) and the “new” economy.

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**Let US Know and Get**  
**Your Name in**  
**Print!**

If you are moving or know someone who is switching firms . . . let us know.

Contact: [info@yvcs.org](mailto:info@yvcs.org)



**EXPOSE YOURSELF**

The Young Venture Capital Society is creating a resume book for **member's only**. The YVCS is constantly approached by a variety of venture capital and private equity funds for potential candidates. If you are a venture capital job seeker this is an additional way to gain exposure to funds.

If you are a **member** and have not already done so, please provide the YVCS with your resume/cv.

If you are interested in having your information included in the resume book, please first register online at [www.yvcs.org](http://www.yvcs.org) - registration and then provide us with your background information.

**Career**

**Link**

Coming in **March** – the career link, allowing members to search some of the open jobs

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**THE LIGHTS ARE BACK ON**

***[But This Time A Dimmer Switch Has Been Installed.]***

For the past two years most early stage start-up companies (companies receiving seed money and or 'A' round financing from venture capital or private equity groups) has been unchanged—or a nice way of saying non-existent. This early round ice-age has been rumored to be in the beginning stages of a thaw but there has been little evidence confirming this. Now, however, figures for the second quarter of 2004 show that the funds are beginning to flow into to pre-revenue companies at a greater pace than seen in about two and half years.

The numbers are indeed positive for seed and early stage companies; according to the PricewaterhouseCoopers/Thomson Venture Economics/National Venture Capital Association MoneyTree Survey accounted for 36.8% of all companies funded in the second quarter, a level not seen since the first quarter of 2001,

A *snapshot* of the report further stated that:

1. **Venture Investing** rose to \$5.6 billion during the second quarter from \$5 billion in the first quarter of 2004.
2. **Year over Year** investment was up 11%.
3. **Number of Deals** also rose to 761 in the second quarter, up from 686 in the first quarter of the year and up from 727 in the second quarter of last year.
4. **Information Technology** segment (software, hardware, etc.) received its largest infusion of cash in over two (2) years with \$3bn invested (294 total deals); four of the five top deals in Q2 were for software related companies.
5. **Health Care** posted an increase (albeit somewhat muted), as it posted a 4% increase in the number of deals with the total number of deals reaching 117.

Although, the numbers are not as eye-popping as they had been in previous years (pre collapse) they have excited most people in the venture industry, which, looking at the negative returns over the past three years it is easy to imagine why.

**Good News for Early Stage Companies.**

The signs of life in seed and early stage investing seem to be gaining strength as year over year percentage numbers are increasing, with investment activity rising to 36.8% from 33% the quarter before. In dollar terms, funding rose about 34%, quarter to quarter. Year to year, the number of investments in seed and early stage companies remained about the same, but funding in dollar terms rose 19%. While, in historical terms, the current investment climate is still chilly (compared to the high of the fourth quarter of 1995, when 50.7% of funding went to seed and early stage companies) it has increased from its nadir seen in the fourth quarter of 2001 (28.5% for seed and early stage deals, according to the MoneyTree data).

**Round D, et. al.**

Funding for later stage or further developed (egad, cash flow positive) companies did not decline in the second quarter of 2004 but it also did not increase; instead it was pretty stagnant at 18%. Some would say that is a result of lack of exit strategy (either through M&A or IPO) but it would seem that later stage companies (who were early stage in 2001) have either vanished or readying themselves for some type of positive liquidity event (e.g., positive liquidity events, IPO, M&A, etc.). For the most part, later stage companies can expect to see less and less cash as those companies and the venture funds that invested in them have reached the end of their investment cycles.

# University and Investment Banking Captains



## The Role of the Captain

The captain is a critical part of the YVCS organization, and is responsible for creating and spreading awareness about upcoming events, products and services. Moreover, they are the mouthpiece or conduit for attendees to voice changes or improvements on YVCS products. They should be seen as leaders and a significant component of the management structure, as their knowledge will often be relied upon by the directors and officers of the YVCS.

## Benefits to Becoming a Captain

As sign of appreciation and recognition, University and Investment Banking captains will be highlighted on the website, newsletter and will be an integral part of management's effort to formulate compelling products. In addition, prizes for top performing captains will be awarded based on their attendee and membership production. Furthermore, captains will attain complimentary event entry and membership as a result of the aforementioned attendee and member production. And finally, captains eager to become increasingly involved in the organization and management of YVCS will likely have an opportunity to take on more responsibility.

## Who Should Apply

In the eyes of management, the captain is an extremely important role. A role for a driven, intelligent and passionate individual at either a university or investment bank.

## Next Steps

Should you be interested in pursuing this opportunity, please contact us at [www.yvcs.org](http://www.yvcs.org).

## Old Money/New Investments.

Funding for start-ups in that category has risen steadily from a low of 7.7% in the second quarter of 2000 to a high of 20.6% in the fourth quarter of 2003, the data show.

Since the collapse there has been very little out flow of cash from funds created on or near the year 2000 which has resulted in many venture funds investing in non-traditional venture investments (e.g., one venture fund, stated that they actually considered buying a cell phone tower because the underlying land was close enough to silicon valley that they thought there could be a real estate speculation play). However, now that the thaw is underway, much of the dry powder sitting on the sidelines has been used to fire cash into new investments.

In total, 229 early stage companies and 51 "seed" companies were funded during the second quarter, receiving \$1.9 billion, or 22% of the quarter's investment, the highest in seven quarters. In the first quarter of the year, 193 early stage and 39 "seed" companies attracted \$932 million. By comparison, 2,894 early stage and 670 seed companies that commandeered \$29 billion in 2000 during the tech boom, or 43% of the deal flow that year.

'The increases in early-stage funding is a promising sign that older companies already in portfolios are now healthier and may be self-sustaining and new investment can be focused on emerging companies and technologies,' said Jesse Reyes, vice president of Thomson Venture Economics. "Increased valuations across the board are probably linked to better equity markets in the first half of the year, and robust companies in the investment pipeline."

## Life Science (bio technology) (biotechnology and medical devices).

- Near historical highs.
- Investments in that sector totaled \$1.41 billion, or 25% of the quarter's venture capital.
- Investments fell in biotechnology companies, some analysts called it a blip, not a trend. Eighty-five biotech companies attracted \$923 million, down from the \$968 million that went into 77 biotech companies in the first quarter of 2004.
- 70 medical-device companies were funded which is a jump of 40% to \$485 million; that compares with the \$344 million that went to 56 companies in the first quarter of the year.

## Media & Entertainment.

- Led by two deals--\$60 million for Si TV, a Latin-theme cable television network; and
- \$70 million for online publisher TechTarget.com, of Needham, Mass.

## Telecom.

- Pulled in \$133 million.

## Semiconductor.

- Seventeen semiconductor companies raised \$104 million, followed by 29 medical device companies which raised \$102 million.

DESPITE WHAT YOUR STATISTICS PROFESSOR SAID  
THERE ARE THREE TYPES OF LIES: "LIES, DAMN LIES AND  
STATISTICS."

- MARK TWAIN

## US VENTURE-BACKED IPO ACTIVITY IN 2004 EXCEEDED PRIOR THREE YEARS COMBINED

Source: AltAssets.

**A total of \$11bn was raised by 93 venture-backed IPOs in 2004, more than tripling the IPO activity in 2003 and comfortably confirming the scale of the turnaround in exit fortunes, according to the latest data from the NVCA and Venture Economics.**

NVCA president Mark Heesen said, 'It is interesting to note that 62 per cent of the venture-backed companies that went public in 2004 received their first rounds of funding between 1997 and 2000, immediately before the recession.'

'The public markets are now embracing many of these companies that went through the bubble burst and lived to tell. These organizations had sound business models and did what it took to weather through some very difficult times with positive results. We expect to see more of the same in 2005 as these phoenixes rise from the ashes in a resilient and impressive manner,' he continued.

In 2004 the technology sector saw 42 venture-backed companies raise a total of \$6.6bn and the life sciences sector 41 companies raise a total of \$2.4bn. The five largest IPOs of the year spanned five different industry sectors: semiconductors, internet, entertainment, exploration and fitness.

As of 30 December, 69 of the 93 companies were trading at or above their offering price.

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## SINS OF THE TECHNOLOGY BUBBLE

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### The Economic Cycle

The late 90s represented the longest economic cycle in the history of this country. Stable interest rates, a rising stock market, low unemployment and significant growth in personal wealth are the hallmarks of the prosperity, which many enjoyed. It is not unfair to say that many believed the economic cycle had been conquered. It may take years for economist to debunk how quickly the crash came about and how so many could be so wrong. Maybe it is a simple principle that most people are optimists!

Main Street following Wall Street clearly emerged as a trend which maybe here to stay. With the emergence of 401(k)s, IRAs, SEP Plans and Keoghs, many Americans fortunes are tied to the fortunes of stock market. The reality of the market is that investors must monetize their positions to realize any gains. Starting in 1998, there were several large drops in the stock market major indexes and almost immediately the market was pushed up by new investors. Some market analyst point to the exiting of VCs, CEO and corporate insiders in large positions as a sign that those "in the know" were trying to get out. Inevitably, the number sellers and the volume of shares being sold subsumed the

Certainly, employment trends of young companies created their own demise. To induce talented employees, young companies granted lucrative pay packages including, cash, option grants and perks. The competition from other young companies became fierce, creating an environment of significant turnover at all levels of a company. On the surface this seemed to be a positive development for employees. However, this lack of stability cannot be underestimated in the inability for many companies to execute their strategies and develop "institutional history" which would have created solid foundations.

### Follow the Herd.

The most intractable element of investing that neither VCs nor those investing in public markets seem to be able to shake is the need to follow a successful formula. Investing public and private markets follow the Gaussian Curve formula (see the Gaussian Curve below), which shows that most of the money investing in any particular area will enter at the point when the market has reached its peak. The reality is that those investors that get in "early" will receive the largest benefits and most people will perform at average market rates. The question of how to accurately time the change of market shifts should probably be left to Chinese philosophers, unfortunately venture capital has firmly embraced the notion the following a proven successful model lowers risk and is a good gage for their potential returns in portfolio companies which are new or competing entrants in profitable arenas.

Whether you reference BtoB, BtoC, ecommerce, fiber optics, stents, or sexual performance enhancers, there was no shortage of areas which were born and ignited copycats and fierce competition. Obviously, their will always be competition where there is sufficient market size. However, venture capitalists should be the most wary of the slippery slope nature of being the 2<sup>nd</sup>, 4<sup>th</sup> or 10<sup>th</sup> entrant to a new market.

### Where are we today?

Past is Prologue. The economy is in the mist of a slow recovery with employment and markets struggling to return to the very active levels of the 90s. Many expect that those

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## SINS OF THE TECHNOLOGY BUBBLE

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levels may never be reached since they reflected flawed economic fundamentals (or a lack thereof). The tech bubble has faded into the past and has paled in comparison to the investment banking scandals, corporate fraud and mutual fund scandals which have erupted.

Past Is Prologue.

How many lessons will be learned from the methods and practices of VCs during the 90s is yet to be seen. The cycle of new funds and fundraising has just begun and will take several years to determine the new investment platforms of VCs going forward. However, one thing is certain, venture capital is inherently risky and there will always be pundits that will look back on their investments and say you should have known better.

## IRREVOCABLE LIFE INSURANCE TRUST MAY PROVIDE FLEXIBILITY DURING ESTATE TAX UNCERTAINTY

By: Kevin R. Luchetta, CFP®, Northwestern Mutual Financial Network

Recent changes to the estate tax law and the Senate's rejection of a proposal to permanently repeal the federal estate tax leaves many wondering how important estate planning will be in the future. Will there be an estate tax? Trusts are frequently used to minimize estate tax liabilities, but in light of the estate tax uncertainty, is an irrevocable life insurance trust still a relevant tool and can it provide flexibility?

First, it is important to understand that there is an estate tax now, and there will probably continue to be an estate tax. The defeat of attempts to make the estate tax repeal permanent underscores this likelihood. Under the current law passed in 2001, the estate tax is phased down through 2009 and then goes away in 2010. However, the tax returns at a top rate of 55 percent for 2011 and thereafter. Additionally, many states are imposing state inheritance and estate taxes to restore revenue lost by the federal changes.

Life insurance can be a powerful estate-planning tool, because it can replace income, provide liquidity at the insured's death and serve as a vehicle for passing on assets to heirs. Choosing an appropriate ownership structure for a life insurance policy is very important. In some situations, setting up a trust is the best solution to help remove assets from the taxable estate and minimize estate tax exposure.

An irrevocable life insurance trust (ILIT) is a type of trust that often has a life insurance policy as its sole asset. A third party acts as the trustee and controls the property according to the trust terms – it cannot be revoked or modified by the insured.

Life insurance proceeds are payable to the ILIT, which means they are not included in the grantor's estate, and therefore the trust and beneficiaries will receive the full amount of the proceeds free of estate and income taxes. An ILIT might be used, for example, when naming a spouse as the owner would create a tax problem and the children are minors. If an ILIT is included as part of an estate plan, here are just a few of the flexible provisions that should be considered to accommodate possible changes in the future:

Trustee provisions:

- Authority to access policy values during the insured's lifetime.
- For single life policies, opportunity to name the spouse of the insured as trustee.
- Power to add new beneficiaries or terminate the trust.
- Option of appointing a corporate trustee to exercise broad discretion and provide long-term management.

Other provisions:

- Rights for the beneficiaries (and the insured with certain limitations) to replace the trustee.
- Control over whether loans may be made by the insured (or others) to the trust or vice versa assuming arm's length terms.

Even if the estate tax is fully repealed, there are situations where keeping an ILIT makes sense. For example, a spendthrift provision would protect beneficiaries from creditors, professional management of assets could be helpful, or distribution restrictions may reduce the risk of unwise spending of assets.

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