

# *Silicon Valley Roundtable*

## *National Association of Business Economists*

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### **Venture Capital in 2002: A Return to Pre-Boom Normalcy**

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After 18 months of spiraling downward, the climate for venture capital investing is showing early signs of a turnaround. The \$7.1 billion invested in the fourth quarter of 2001, up from \$7 billion in the third quarter, reversed a freefall that began in the third quarter of 2000. Combined with some signs of life in the IPO market, this may presage a return to some stability in the venture industry in 2002.

Despite the uncertain economic environment, U.S. venture capitalists invested a total of \$36.5 billion in 2001. While this was less than 40% of the \$91.6 billion invested a year earlier and although deal volume was less than 50% of that of the previous year, 2001 was still the venture industry's third best year overall. If the Internet boom years of 1999 and 2000 are taken out of the calculation, the 2001 venture capital market looks extremely robust in historical perspective. In terms of volume, it substantially exceeded the \$19 billion invested in the pre-bubble year of 1998.

As Silicon Valley was ground zero for the venture funding of the Internet boom, the impacts of the rapid deceleration of the venture industry over the last five quarters have been pervasive. The portfolios of many venture capitalists have seen steep declines in value. Venture-backed companies have imploded. Venture industry publications have gone out of business. Funds have handed money back to their investors, and billions of dollars of dot.com investments have been written off. A major indicator of the fragile state of the venture industry in the Valley in 2001 was the sudden availability of office space on Sand Hill Road.

In some respects, 2001 amounted to a cleansing of the venture industry in the United States. During the period 1999-2000, a lot of new money and new players were attracted to the venture industry. The new money was, in many instances, dumb money and a number of new players had questionable qualifications and questionable intentions. Everyone wanted a piece of the boom. During this period, hype and deal making skills replaced management capabilities and industry and technology knowledge. With a return of some sanity to the market, much of this money and many of these players have been washed away.

Looking back at 2001, here are some of the major changes from the previous year:

- **The flight of corporate investors (once again).** The later part of the 1990s saw an explosive growth of venture investing by large corporations in the ITT sector. Estimates put corporate venture capital investments in the United States at between \$17-18 billion in 2000. By comparison, corporate venture capital investments amounted to \$ 9.5 billion in 1999 and only \$1.5 in 1998. At the height of the boom, it was estimated that there were around 400 companies actively making venture investments. A panel for *Red Herring* magazine in 1999 predicted that corporate investment activity would overtake traditional venture investment in start-ups by 2005. Today, many corporate venture capital operations have ceased their investment activities and liquidated their portfolios. Estimates suggest that venture investing by corporations in 2001 fell to about 10% of its 2000 level. As in previous venture cycles, the corporate funds were among the first to abandon ship when things got tough.
- **The return of a technology focus.** The two sectors that showed the most strength in 2001 were software and biotechnology. The life sciences captured a greater percentage of overall investment than in recent years. The sectors share of total investment rose from 9% in 2000 to 17% in 2001. Eighteen months ago, venture investors were putting a significant portion of their initial investments into web retailing and e-commerce; now they have pretty much abandoned these sectors. Not only has the focus changed but the quality bar has also gotten much higher.
- **A weak exit market.** The 2000 IPO market was off by 90% from a year earlier in terms of both the number of offerings and the amount raised. The year 2001 ended with 37 venture-backed IPOs for a total offer size of \$3.2 billion compared to the previous year's record volume of \$21.08 billion. Overall, the 2001 IPO market looked a lot like the pre-boom 1998 market, which raised \$3.6 billion. While the 2001 M&A market fared a little better in terms of the number of transactions, down only 23%, the value of M&A transactions plummeted by 80%. After a modest showing in the third quarter, the venture-backed IPO market seemed to rebound in the fourth quarter, as 14 venture-backed companies, mainly in the medical/health industry, raised \$1.45 billion.

- **Venture capitalists in crisis mode.** With the moribund IPO and weak M&A markets limiting exit opportunities, venture capitalists devoted much of their time and capital in 2001 to keeping their existing portfolio companies afloat. This left them with little time or inclination to invest in new start-ups. Overall 23% of the venture capital invested in 2001 went to early stage and start-up financing compared to 36% in the previous year. However, by the close of the 4th quarter, the focus was beginning to return to early stage investments. The steep decline in start-up funding that began in the middle of 2000 seemed to have bottomed out in the third quarter of 2001 and turned around in the fourth quarter.
- **A return to sanity in pre-money valuations.** In 2001, the average U.S.-based technology company sought a pre-money valuation of \$150 million. In 2001, the average was about \$25 million.
- **A slowdown in fundraising.** In 2001, \$48 billion in new money was raised by venture funds. While this was roughly half of the \$90.1 billion raised the previous year, it was still the third largest amount on record. The slowdown in fundraising reflects the existence of a strong capital reserve resulting from the increased fundraising that took place in 2000. Going into the year, venture capitalist had around \$50 billion of capital on the sidelines, so a slowdown in fundraising was not surprising. Coincident with this slowdown, 2001 also saw a much more discriminating attitude on the part of limited partners. It was much more difficult to raise new funds without a good track record. Moreover, LPs began to be much more aggressive, pushing for greater transparency on fund performance and management fees and demanding more accountability.

### *A View of the 2002 Venture Capital Industry*

The increase in venture activity in the fourth quarter of 2001, combined with both an improved IPO market and a spark in early stage funding in the quarter, augurs well for the industry in 2002. An improving IPO market is a particularly important sign as it is one of the key pulse points of the venture industry. Overall, the venture industry in 2002 is likely to have many of the characteristics of the pre-boom industry of 1998 in terms of focus, stage of investment, the nature of venture investors, etc. Some of the major things to look for in 2002 include:

- Venture capital investments will stabilize at above the levels that preceded the Internet/ dot.com boom.

In 2002 the level should be in the \$ 32-33 billion range or about \$8 billion a quarter.

- The amount of money going to first round investments will start to climb and by the fourth quarter should begin to approach the levels of 1997 and 1998 or 35 % of new investments.
- Venture investments in life science investments will increase to between 20-25% of the market. Investments in telecom and optics companies will remain weak.
- There will be increased pressure on management fees as LPs, particularly pension funds, become more aggressive in demanding accountability from their venture fund managers.

### **Simon Defeats Riordan in GOP Primary, Will Face Davis in November**

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On March 5, 2002, businessman Bill Simon, 51, defeated Richard Riordan, 71, the former mayor of Los Angeles, in the Republican gubernatorial campaign. Simon soundly whipped Riordan by a margin of 49-31 percent; a third candidate, Bill Jones, 52, the secretary of state (and the only candidate with a statewide office) got 17 percent.

The outcome was a political surprise. The Bush White House had recruited Riordan, a popular moderate, to run against the Democratic incumbent governor, Gray Davis, who was under voter fire for his handling of California's energy crisis in the summer of 2001. Though somewhat gaffe prone, Riordan stood closer to the state's political center than the other Republican hopefuls. As late as January 2002, he enjoyed a huge 28-percentage point lead in the GOP race and also led Davis in statewide polls.

### *California Increasingly a One Party State*

The GOP has been increasingly marginalized in recent elections. While Republicans enjoy a 10 percent among nationwide voters, they are 10 points behind in California. The GOP held the governor's mansion for 16 years before Davis was elected in 1998. However, the decline of statewide defense industry and immigration from other states and countries has made California more liberal and less white in the past decade. Republican governor Pete Wilson, Davis's immediate predecessor, alienated the growing number of Latino voters with his 1994 advocacy of Proposition 187, which was aimed at restricting illegal aliens. The Democrats have both California Senate seats and a big edge in the House.

Party pros welcomed Riordan, an economic conservative, with liberal views on social issues and potential appeal to independent voters, who could offset the Democrat lead in voter registration (45-35 percent). Riordan favors abortion rights, gun control, welfare for the children of illegal immigrants, and "domestic partner" benefits for homosexual couples. Conservative Republican House members, Dana Rohrabacher and Chris Cox endorsed Riordan as the candidate most likely to unseat Davis.

### *Riordan's Electoral Waterloo*

Riordan's lead in the polls spurred the Davis camp to go on the attack. Garry South, Davis's political strategist, launched a series of ads accusing Riordan of talking out of both sides of his mouth on abortion. The Davis ads sought to discredit the GOP's strongest candidate in the November election while Davis ran unopposed in the Democratic primary. The ads did the job.

Moreover, Riordan failed totally to solidify his own party base. Three former Republican state party chairmen issued a statement declaring, "Dick Riordan is no Republican." Worse was to follow. George Deukmejian, the popular ex-governor who supported Bill Jones, attacked Riordan for supporting the campaigns of prominent Democrats, including Gray Davis. Deukmejian declared he could not support Riordan. In the meantime, Bill Simon, a political novice but a man with the resources to finance his own campaign, scored well with the conservative GOP voters who turn out for primaries. He also benefited from the endorsement of Rudy Giuliani, former mayor of New York, for whom Simon worked for as a federal prosecutor.

Riordan ran a disastrous campaign. He relied on prominent Democratic advisers, most notably Susan Estrich, the political strategist for Michael Dukakis in the latter's ill-fated 1988 presidential campaign. In attempting to defend liberal positions against Davis ads, he lost the support of his Republican base and made an enemy out of the influential George Deukmejian. Simon partisans are encouraged by their candidate's upset win. They point to 1966 when then Democratic governor Pat Brown intervened in the Republican primary to elect a "conservative extremist." Brown's effort succeeded but Ronald Reagan beat him soundly that fall.

### *The Outlook for November*

Conservatives have some grounds for optimism. Gray Davis's approval rating is only 47 percent among registered voters and he must also deal with a projected

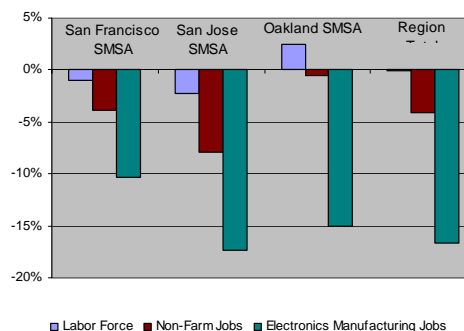
budget deficit of \$17 billion. Simon hopes that a middle of the road campaign on issues such as education, the state budget, transportation, water, and power will unseat the relatively unpopular governor. Davis, however, will emphasize social issues, such as abortion, the environment, and gun control that have worked for Democrats in the past. Davis has also attacked Simon as a carpetbagger new to the state with extreme right-wing views. Key to Simon's chances is inroads into the Latino and independent vote, which is not a likely prospect.

### **Silicon Valley Real Estate: A Mixed Picture**

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Both commercial/industrial and residential real estate follow the employment and population trends of the Valley. Last year's weak real estate market replicated the sharp decline in jobs and the more modest decline in labor force that occurred in 2001. The most significant of the effects of the slowdown has been in the San Jose SMSA, with declines of about 8% in non-farm jobs and 17% in electronics manufacturing jobs from February 2001 to February 2002. The San Jose and San Francisco SMSAs also lost workforce, while the Oakland SMSA labor force increased about 2% over the period. Although the decline in jobs continued into early 2002, a moderate turn around in the local economy is projected by the Silicon Valley Roundtable, which should lead to modest improvements in the commercial real estate market by the end of 2002. The residential real estate market has already started its rebound.

**Percentage Change in Silicon Valley Labor Force and Jobs: February 2001 to February 2002**



Source: California EDD

**Commercial/Industrial:** Boom and bust cycles have plagued the Silicon Valley commercial real estate market for at least two decades. In the mid-1980s developers overbuilt and tenants over committed to office and R&D space just before the decline in the

local semiconductor industry, leaving “see-through” buildings and vacant parking lots everywhere. In the early 1990s, as the region’s defense industry slowed with the end of the Cold War, the demand for commercial space again fell. Today, after the implosion of the dot-com industry, it is estimated that around 7 to 8 million square feet of office space is available for lease in Silicon Valley. During 2001, office vacancy rates in central Silicon Valley jumped from about 2% to 16% while average lease rates plunged from over \$60 to about \$40, with Palo Alto experiencing some of the sharpest changes. Some analysts warn that vacancy rates may reach over 20% before a recovery is firmly underway. Warehousing and other commercial/ industrial space has followed similar patterns. By third quarter 2001, for example, warehousing vacancy rates were over 9%, compared with about 1.5% just a year before. Average rents decline about 15% to 20%. It may take several years before the excess commercial and industrial space is absorbed, and also another tech boom. Most commercial properties, however, are still providing a positive cash flow because of long-term leases. Conditions are not yet dire for commercial landlords but may be as current leases expire. In the mean time, Silicon Valley companies will have an easier time finding space, but the commercial real estate construction will be at a near standstill.

**Residential:** The residential market is in better shape than the commercial/industrial market. Apartment rental rates fell by about 8% in 2001 and vacancy rates climbed a few percentage points, but still are under 5% for most areas. Apartment construction continued into 2001, increasing the inventory of available housing, while the labor force and jobs in the region declined, which relieved the housing shortage that intensified in 2000. After a year of stagnant to declining housing prices and expanding inventories, owner-occupied housing sales jumped considerably early in 2002. Low interest rates and an influx of buyers have reduced the available home inventory, and there are signs that some homes are being sold for over the asking price. The forecast is for moderate increases in housing prices and rental rates through 2002, mainly to keep pace with inflation.

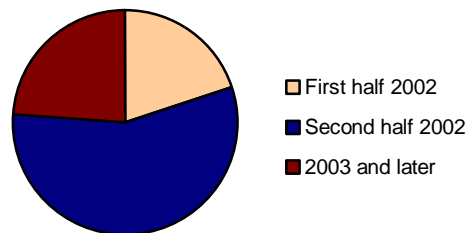
**Silicon Valley Outlook:  
SVRT Membership Survey Results**

The economic climate for Silicon Valley remains mixed. Santa Clara County electronics industry employment continued to decline, albeit modestly, in February 2002, while the San Francisco SMSA electronics industry reported a 2% gain. In early March, the Semiconductor Industry reported U.S. sales of semiconductors in January 2002 were about 0.1% below sales in January 2001, and signs of a recovery are

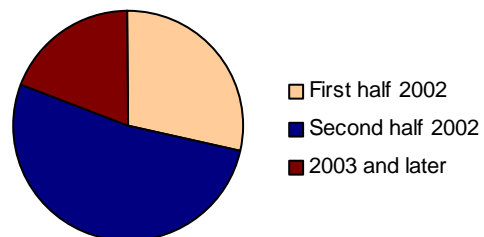
evident. The biotech industry is doing well, and absorbing some of the job losses from other industries. The overall belief that the Valley should start growing later this is reflected in last year’s SVRT membership survey conducted in November/December 2001. The majority of respondents indicated that both the United States and Silicon Valley would recover in 2002, most likely in the second half. Current signs are for an earlier recovery of the national economy, due in part to higher defense spending and strong consumer spending.

The majority of respondents to the survey also indicated that the recession was the most important problem facing Silicon Valley this year. Housing and infrastructure ranked highest in the membership survey conducted in December 2000, and were noted by several respondents as remaining problematical for the Valley. Transportation and labor force constraints were also noted as issues that need to be addressed. The results are given below. (Based on 23 respondents.)

*When will recovery of the U.S. economy begin?*



*When will recovery of the Silicon Valley economy begin?*



*Numbers of respondents indicating the following are major Silicon Valley problems.*

