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August 1997

Trends in Venture Capital Funding in the 1990s

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Trends in Venture Capital Funding in the 1990s

Nicole R. Onorato

Nicole R. Onorato is an intern in the SBA's Office of Advocacy and a student at the University of Baltimore Law School. This paper was written under the supervision of Terry E. Bibbens, entrepreneur in residence, and Fred A. Tarpley, Jr., chief economist, U.S. Small Business Administration, Office of Advocacy.

U.S. Small Business Administration
Office of Advocacy
Washington, D.C.: August 1997

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NTIS document number PB98-127244

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INTRODUCTION

Today's entrepreneurs need new sources of money to fund the development process of their innovative companies. The lack of a revenue history makes it almost impossible for a small firm to obtain conventional financing such as bank loans. In these instances, entrepreneurs with marketable products may seek financing from venture capitalists. Venture capital investments provide the needed cash for companies to develop technologies and products which, in turn, generate jobs, exports, and taxes that keep the United States competitive.[1]

In the past, there have been many venture capital firms that specialized in small seed investments. Over the years, venture funding has matured, and its nature has changed as a result of successful investments made in new innovations. Although the number of professional venture capital firms has decreased, the size of the average individual fund has greatly increased. Larger investments are being made in single companies that have a need for large amounts of cash for fast development.

As the venture community has grown, opportunities for Small Business Investment Companies (SBICs) have begun to increase also. With professional venture capital firms investing larger amounts of money, SBICs have been able to fill in some of the gaps by providing smaller investments to companies that need less financing. In addition, even more of the venture capital needs of smaller companies have begun to be met by the accredited investor or "angel" financing community. Through financing provided by large professional firms, SBICs, and angel investors, venture capital can be obtained by companies of different sizes with varying needs.

VENTURE CAPITAL INVESTMENTS

From 1981 to 1985, the average amount of venture capital funds needed for a company's first five start-up years was $7 million. From 1988 to 1992, the average amount needed was $19.1 million, a 173 percent increase.[2] Today a company needs an average of $16 million in venture capital during the first five start-up years, a 129 percent increase from 1985. It is an understatement to say that venture financing is very important to a company's success: two-thirds to three-fourths of a venture-capital-backed company's total equity is supplied by venture funding.[3]

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[1] Coopers & Lybrand, *Fourth Annual Economic Impact of Venture Capital Study* (New York: Coopers & Lybrand, 1994).

[2] Ibid.

[3] Coopers & Lybrand, *Seventh Annual Economic Impact of Venture Capital Study* (New York: Coopers & Lybrand, 1997).

In the United States

The annual amount of investment made by venture capital firms has been rising over the past several years. In 1991, $3.4 billion in venture capital was invested; in 1992, $4.1 billion; in 1993, $4.9 billion; in 1994, $5.3 billion; in 1995, $8.0 billion; and in 1996, $10.0 billion.[4] By the end of the first quarter of 1997, $2.4 billion in venture investments had been made.[5]

The average yearly venture financing per deal has also been gradually increasing over the years, with the exception of a very small decrease seen in 1996. In 1991, the average venture capital invested per deal was $4.1 million; in 1992, $4.3 million; in 1993, $5.0 million; in 1994, $5.1 million; in 1995, $6.8 million; and in 1996, the average invested per deal was $6.7 million.[6]

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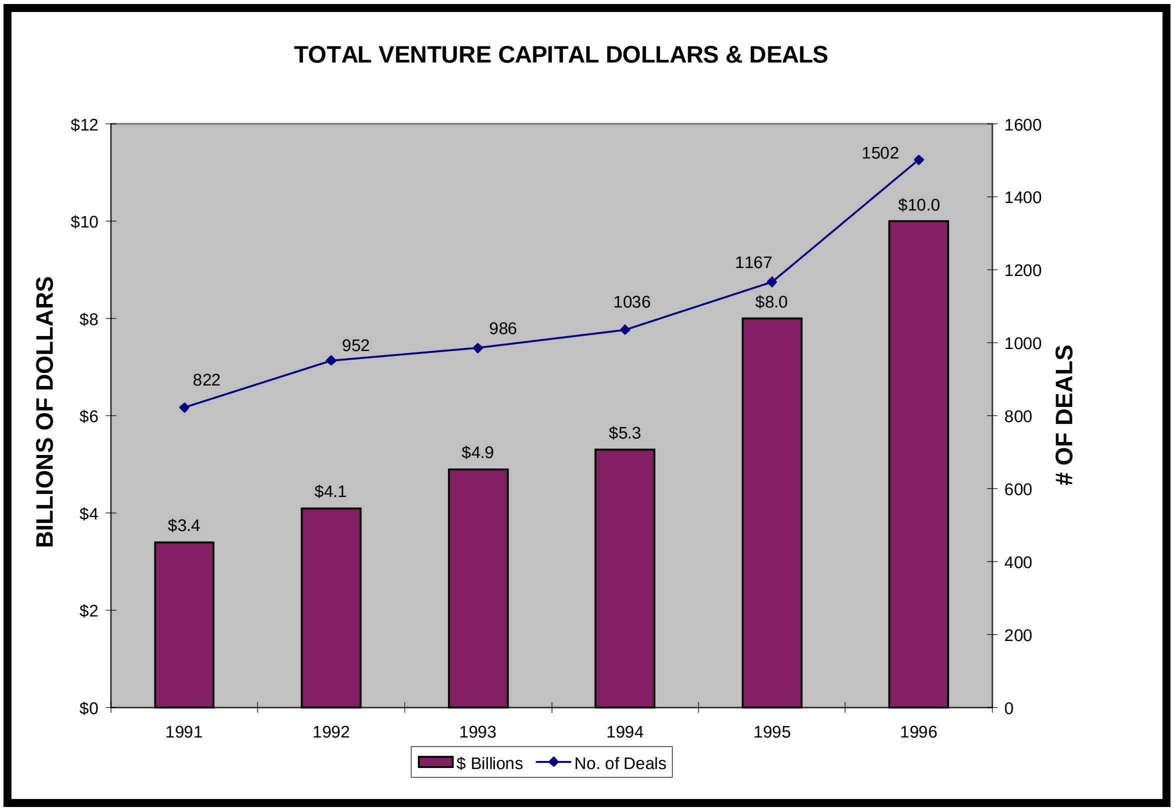
[4] Phillip Horsley, *Trends in Private Equity* (San Francisco, Calif.: Horsley/Bridge, 1997); National Venture Capital Association, *1996 Annual Report* (San Francisco, Calif.: VentureOne Corp., 1997).

[5] Coopers & Lybrand, *Money Tree Report — Q1 1997 Results* (New York: Coopers & Lybrand, 1997).

[6] Horsley, *Trends in Private Equity*. However, in studies done by Coopers & Lybrand the average venture capital invested per deal is lower than amounts provided in the Horsley/Bridge report. Coopers & Lybrand reports that the average venture capital invested per deal in 1995 was $4.3 million; in 1996, $4.7million; and in the first quarter of 1997, $4.17 million (*Money Tree Report — 1996 Results* and *Money Tree Report — Q1 1997*).



Sources: *NVCA 1996 Annual Report* (VentureOne 1997) and Phillip Horsley, *Trends in Private Equity* (VentureOne 1997).

By State

California has been the leader, by a very large margin, in obtaining venture capital investments. Massachusetts places second. Since 1990, California and Massachusetts combined have received more than 40 percent of the total annual venture funding in the United States. Texas, one of the fastest growing markets in the 1990s, placed third in investments for 1996. In 1996, California firms obtained $3.2 billion — a 49 percent increase over 1995. Massachusetts nearly doubled its share with $1.1 billion, and Texas received $593.3 million. Almost every state posted a significant increase in venture investments from 1995 to 1996.[7] By the end of the first quarter of 1997, California was still the leader in investments, obtaining $750.3 million, or 31 percent of the total national venture capital.[8]

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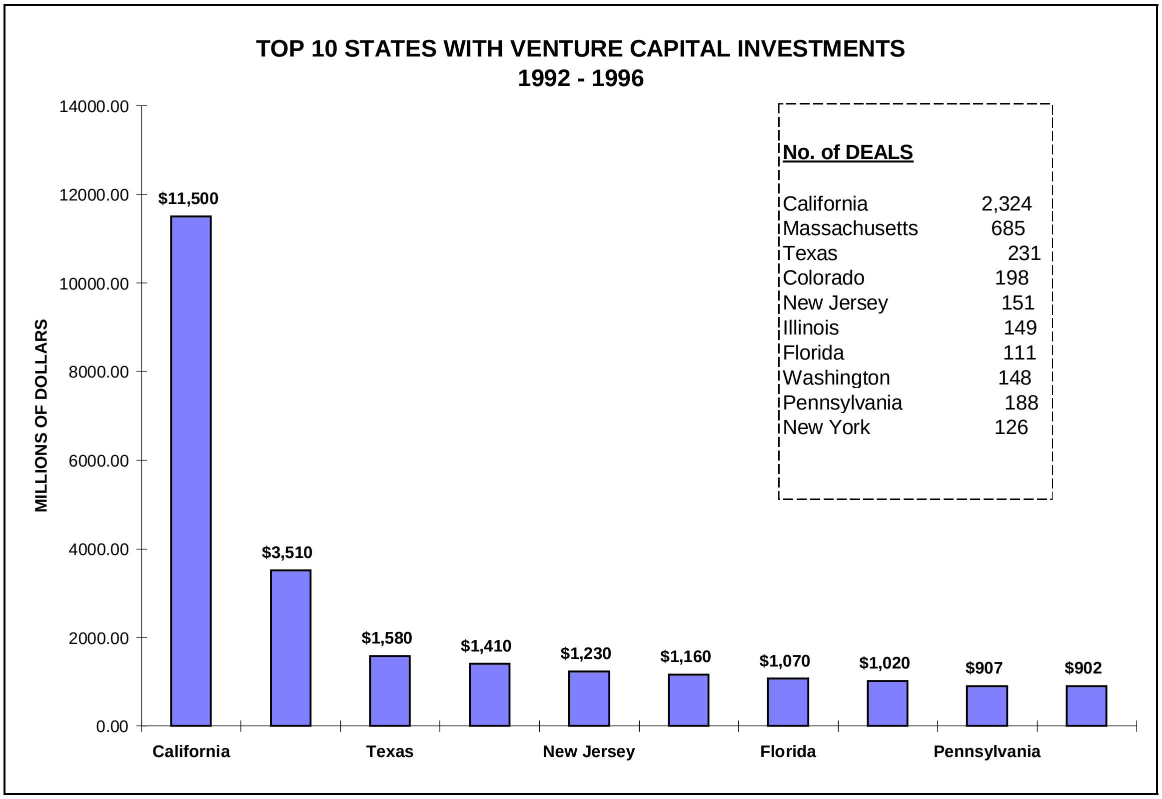
[7] Coopers & Lybrand, *Money Tree Report — 1996 Results*.

[8] Coopers & Lybrand, *Money Tree Report — Q1 1997*.

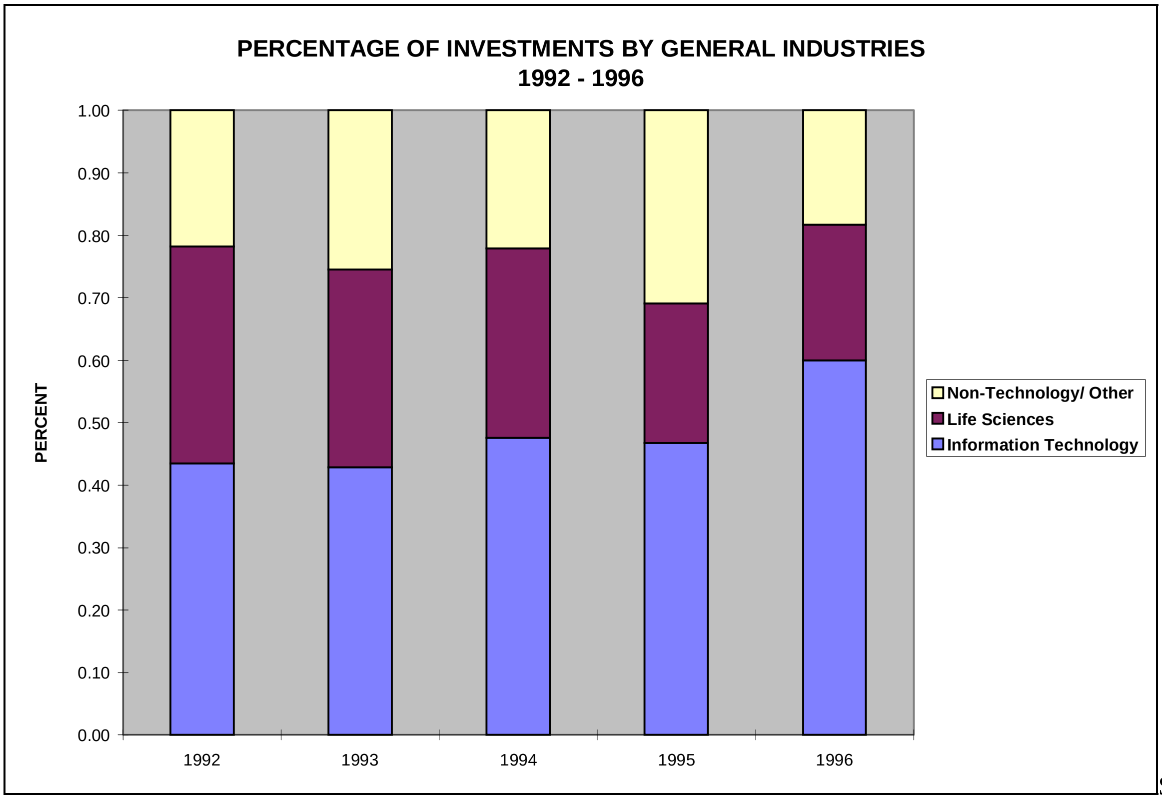


Source: *NVCA 1996 Annual Report* (VentureOne 1997).

By Industry

In 1995, the communications industry received a total of $1.1 billion in venture funding for 175 deals, with the average investment per deal being $6.06 million. The software industry came in second with $750 million. In 1996, the software and communications industries tied, obtaining $1.6 billion per industry in venture capital investments: software had 484 deals with the average investment per deal being $3.29 million, and communications had 289 deals with the average investment per deal being $5.5 million. Technology-based companies received 60 percent of the total venture capital investments in 1996.[9] In the first quarter of 1997, the software industry again received the largest share of venture capital, obtaining $490.9 million, or 20 percent of total venture capital, through 149 deals, with the average investment per deal being $3.29 million. The communications industry received the second largest amount of venture capital investment dollars with 17 percent of total venture

[9] Coopers & Lybrand, *Money Tree Report — 1996 Results*.



Source: *NVCA 1996 Annual Report* (VentureOne 1997).

capital. Technology- based companies again received 60 percent of the total venture capital investments.[10]

TRENDS IN VENTURE CAPITAL INVESTMENTS BY SBICs

Throughout the 1990s, SBICs have increased their funding to small businesses in need of capital. From 1990 to 1996, the total venture capital invested annually by SBICs almost tripled. Contrasted with large venture capital firms that invest only a small amount in start-up companies, SBICs invest more than 50 percent of their funding in small businesses under

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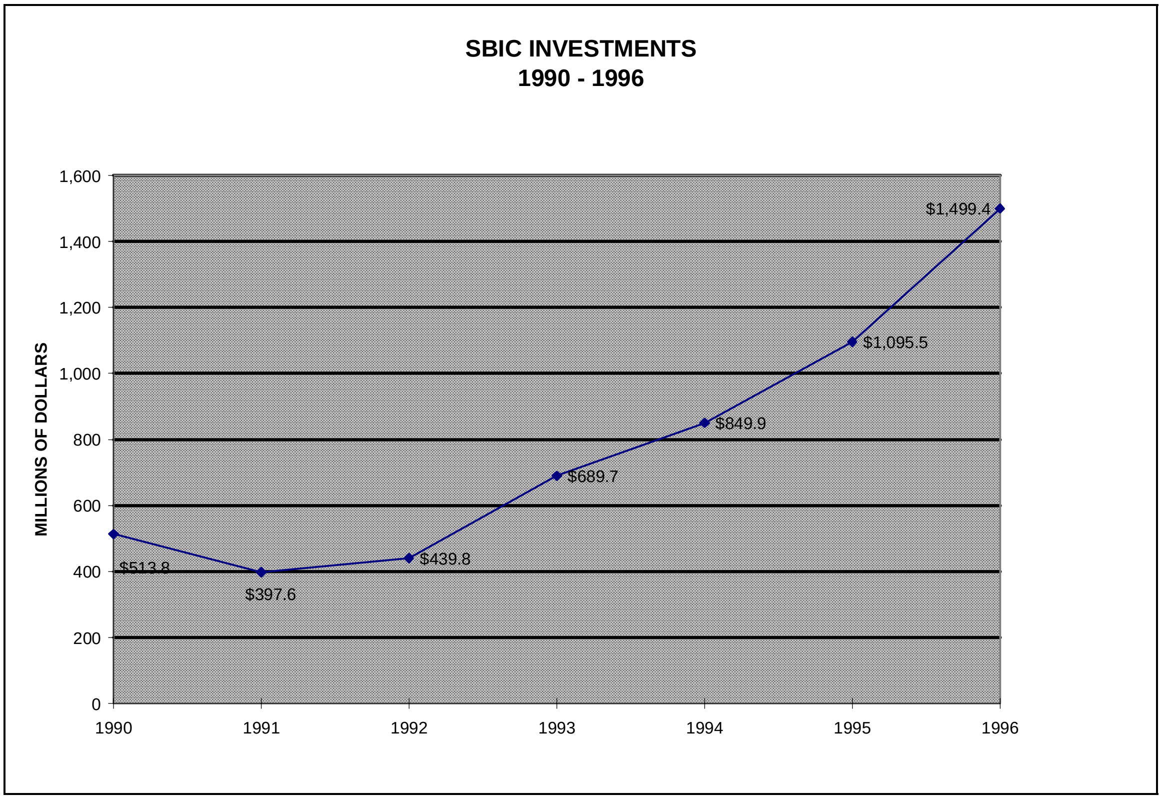
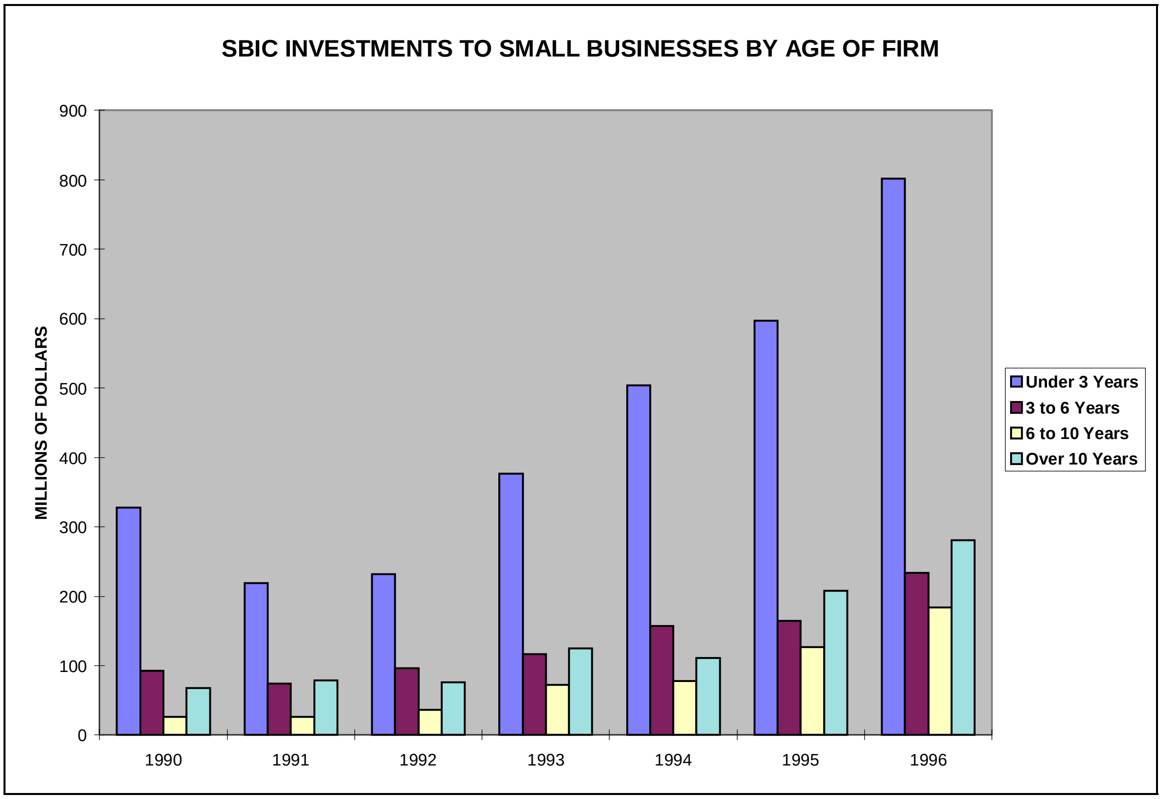
[10] Coopers & Lybrand, *Money Tree Report — Q1 1997 Results*.



Source: U.S. Small Business Administration.

three years of age. As with the investments made by large venture capital firms, California has received the largest annual amount of investment dollars from the SBICs.[11]

[11] U.S. Small Business Administration, *SBIC Program Statistical Package* (Washington, D.C.: U.S. Small Business Administration, 1997).



Source: U.S. Small Business Administration.

TRENDS IN VENTURE CAPITAL FUNDS

In 1985, the professional venture capital community had $19.6 billion under management. By 1995, the total had grown to $43.5 billion, a 122 percent increase.[12] While the capital under management has increased, the number of firms managing it has decreased. In 1990, there was $35.90 billion in venture capital under management by 664 venture capital investment firms; in 1991, $32.87 billion by 640 firms; in 1992, $31.07 billion by 617 firms; in 1993, $34.76 billion by 637 firms; in 1994, $34.13 billion by 591 firms; and in 1995, $37.15 billion by 610 firms.[13]

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[12] Coopers & Lybrand, *Seventh Annual Economic Impact of Venture Capital Study*.

[13] Horsley, *Trends in Private Equity*; National Venture Capital Association, annual reports, 1992–1995.

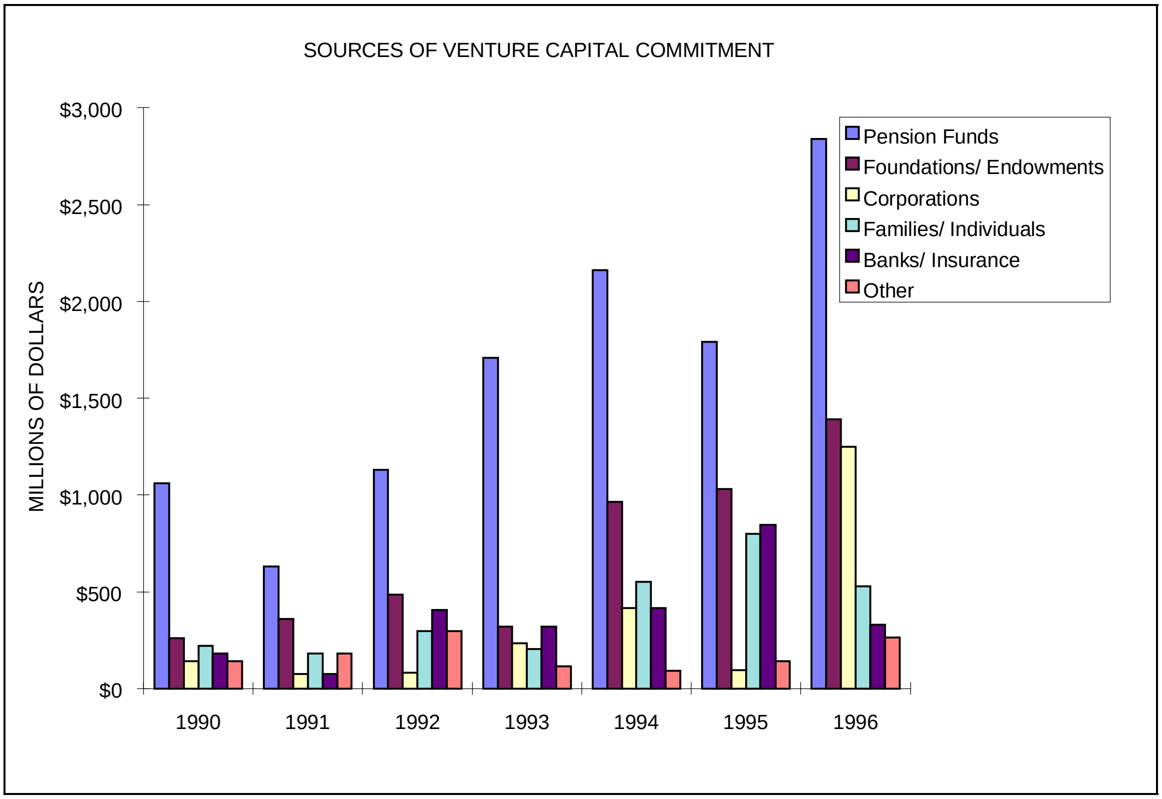
SOURCES OF INVESTMENTS IN VENTURE CAPITAL FUNDS

	1990	1991	1992	1993	1994	1995	1996
PENSION FUNDS	$1.06B	$630M	$1.13B	$1.71B	$2.16B	$1.79B	$2.84B
FOUNDATIONS/ ENDOWMENTS	$260M	$360M	$486M	$319M	$966M	$1.03B	$1.39B
CORPORATIONS	$140M	$ 75M	$ 81M	$232M	$414M	$ 94M	$1.25B
FAMILIES/ INDIVIDUALS	$220M	$180M	$297M	$203M	$552M	$799M	$528M
BANKS/ INSURANCE	$180M	$ 75M	$405M	$319M	$414M	$846M	$330M
OTHER	$140M	$180M	$297M	$116M	$ 92M	$141M	$264M
TOTAL INVESTMENTS	$2.00B	$1.50B	$2.70B	$2.90B	$4.60B	$4.70B	$6.60B

The average size of venture funds has increased considerably over the years. In 1985, the average size of a venture capital fund was $30 million. By 1995, the size of the average fund had almost tripled to $80 million, and by 1996, the average fund grew even more, to $138 million. In 1990, new capital investments totaled $2.0 billion; in 1991, $1.5 billion; in 1992, $2.7 billion; in 1993, $2.9 billion; in 1994, $4.6 billion; and in 1995, $4.7 billion. In 1996, new investments reached an all-time high of $6.6 billion.[14]

Although venture capital investments come from a variety of sources, since 1990 more than 40 percent of the capital per year has come from pension funds. The second largest source of funding is endowments and foundations, with an average of about 20 percent of the funds each year. The fastest growing funding source in the 1990s has been corporations, which contributed 19 percent of funds in 1996 — a $920 million increase from 1990, when they contributed just 7 percent.

[14] National Venture Capital Association, *1996 Annual Report*.



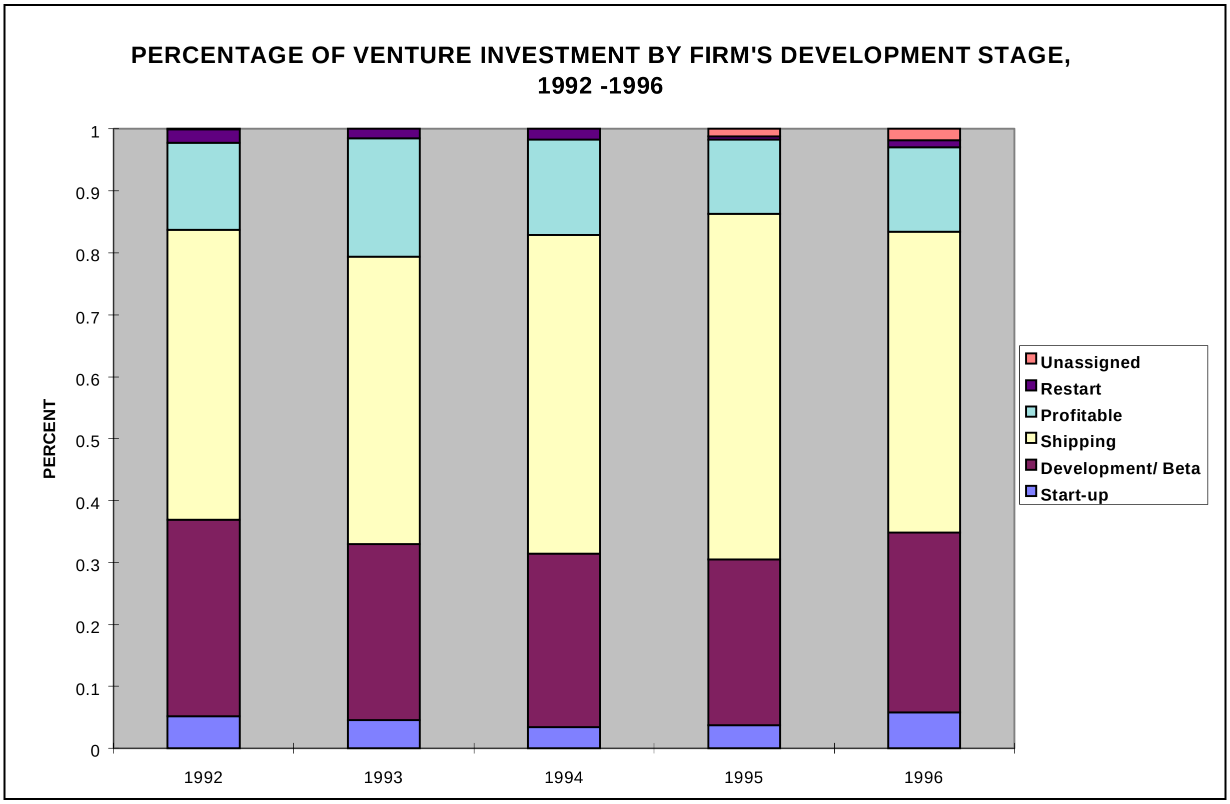
Source: Adapted by author from percentages presented in the *NVCA 1994 Annual Review* (1995) and Phillip Horsley, *Trends in Private Equity* (1997).

PROFILE TRENDS OF COMPANIES IN WHICH VENTURE CAPITALISTS INVEST

When searching for investment opportunities, venture capitalists look for certain characteristics in the potential recipient of their funds. They are looking for companies with the potential for fast growth as a result of innovative ideas and sound management and organization. Many venture capitalists also consider geographic location, industry specialization, stage of company development, and size of investment needed.[15]

Additionally, most venture capitalists insist that three specific criteria be met: (1) the entrepreneur of a company must understand the venture capital process of investment. This assures the venture capitalist that the company owner has done his/her research and is well-prepared; (2) a well formulated and thought-out business plan needs to be in place. This strong management tool helps demonstrate the viability and growth potential of the company, and it gives the venture capitalist the opportunity to evaluate the entrepreneur who will manage the business and measure the investment's return potential; and (3) a written and realistic financial forecast must be provided. The financial forecast

[15] Coopers & Lybrand, *Three Keys to Obtaining Venture Capital* (New York: Coopers & Lybrand, 1996).



Source: *NVCA 1996 Annual Report* (VentureOne 1997)

helps the venture capitalist evaluate annual investment return. Venture capitalists look for an annual investment return of between 30 and 40 percent or more, and a total return of between 5 and 20 times their investment.[16]

IMPACT OF VENTURE CAPITAL INVESTMENTS ON COMPANY GROWTH

Companies backed by venture capital have a rapid rate of growth and provide many job opportunities for educated professionals. Venture-capital-backed companies averaged annual increases in employment of 20 percent from 1990 to 1994, while Fortune 500 companies averaged declines of -0.8 percent. The companies backed by venture capital employ highly skilled workers — engineers, scientists, and managers — at about four times the annual rate — 61 percent — compared with 14 percent in the United States work force overall. By the time the average venture capital company is six years old, it employs more than 200 workers.[17]

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[16] Ibid.

[17] Entrepreneurs Coalition, *Entrepreneurs Agenda 1996–1997* (Washington, D.C.: Entrepreneurs Coalition, 1997); Coopers & Lybrand, *Fourth Annual Economic Impact of Venture Capital Study*.

From 1991 to 1995, venture-capital-backed companies enjoyed revenue growth of approximately 38 percent.[18] Because the average start-up company does not generate significant revenues in the early years of development, it spends its venture capital equity on equipment, inventory, and other necessary assets for growth.

Venture capital helps to accelerate growth in four key areas: research and development; job creation; export sales generation; and plant, property, and equipment. The ability to place venture capital investments in these areas in the critical years of a company's development enables fast growth that leads to future financial success.[19]

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[18] Coopers & Lybrand, *Seventh Annual Economic Impact of Venture Capital Study*.

[19] Coopers & Lybrand, *Fourth Annual Economic Impact of Venture Capital Study*.