Monday, May 10, 2004

Index Strives To Peg True Value Of Venture Capital-Backed Firms

BY BRIAN DEAGON
INVESTOR'S BUSINESS DAILY

An economist has good news for venture capitalists: Your funds are doing better than you might think.

So says Susan Woodward, per the findings of her Sand Hill Index.

The index, unveiled late last year, is one of the most scientific attempts to put a value on privately held companies held in venture capital funds.

VCs, and private companies, are notoriously secretive. But Woodward, in short, uses what little data are out there, and extrapolates, to come up with the index. And she already has fans.

"We endorse Sand Hill's method," said Jesse Reyes, vice president at research firm Thomson Venture Economics. "It's rocket science. Other organizations have been trying to come up with a formula like this for years, without much success."

The good news of the Sand Hill Index is that the value of privately held firms actually rose 40% in 2003. That's way more than the paltry 2.5% increase, to $123 billion, that the National Venture Capital Association says venture capital portfolios rose last year. It's close to the 50% increase in value enjoyed last year by the tech-laden Nasdaq composite index of publicly traded companies.

Why the big difference in findings between the Sand Hill Index and the NVCA report?

Woodward, who heads her own firm called Sand Hill Econometrics, says the performance reports by the NVCA and similar groups lag what's actually happening in the market by about six months.

If she's right, 2004 should be a very good year for VC investors. If private companies are percolating much better than the NVCA numbers indicate, as Woodward believes, that suggests the money flow to investors should begin to boil this year, as venture fund portfolio values rise.

2004 Should Be 'Excellent' Year

That also could mean that more of these private companies will go public and that they'll be hiring more workers. Small companies account for most of the nation's job growth.

"We expect (VC) general partners to report an excellent year for 2004, because they will be showing the increases in value that have already happened," said Woodward.

The NVCA numbers have yet to show such an improvement, she says, because some of the data used to compile VC results is more than a year old.

Also, she says some VC funds have to keep on the books for years investments they've essentially written off.

Getting a good reading of VC funds and of private company performance is never easy. There's a lot of what Woodward calls "dirty data."

Much information released by VC firms is tricky to pin down, she says, because the firms do two somewhat contradictory things: tend to emphasize any good news, while also being overly conservative about the overall picture.

So, Woodward — former chief economist at both the U.S. Securities and Exchange Commission and the Department of Housing and Urban Development — says she spent four years developing a formula to get an accurate accounting of VC-backed firms. The result is the Sand Hill Index.

Both her index and firm are named after Silicon Valley's Sand Hill Road, the address for many of the nation's major venture firms. Her firm, though, is based about three miles from the famed road.

Woodward says the Sand Hill Index lets her subscribers gauge the performance of VC portfolios.

The index doesn't look at the funds per se, but investors can get an idea on VC fund performance by getting an idea of how the private companies in those funds are doing.

The Sand Hill Index's subscribers include the Federal Reserve Board. Other subscribers include venture firms and other fund managers.

The cost is $2,500 a year for the index, which Woodward's firm updates quarterly. There's a $500 rate for schools and libraries.

She says the index also can help to determine who are the best fund managers.

Woodward's index averages out private firm values based on the small percentage of such companies that's she's able to accurately assess.

The Sand Hill Index incorporates a technique called selection bias. It uses all information VCs do reveal about companies and extrapolates that out to get an average.

It currently tracks about 7,500 privately held companies that are operating, have employees, file taxes and have received some VC funding. The index pegs the total market value of these companies at about $275 billion, an average of more than $36 million.

Sand Hill Econometrics also has determined that a $100 investment in the average-performing U.S. venture fund in 1989 would be worth about $1,500 today.

Woodward and her staff has collected data on 65,000 "valuation events." These events — such as rounds of funding, acquisitions, initial public offerings and shutdowns — are used to determine company values.

Thomson Venture Economics and the NVCA say venture funds on average lost value for 11 straight quarters before moving back to the plus side in the third quarter of 2003.

Turned Corner In Late-'02

Most of the money invested by VC firms comes from pension plans, endowment funds and corporations, followed by individual investors.

Woodward, though, says the venture portfolios actually began turning positive near the end of 2002.

Research firm Cambridge Associates, which collects data on portfolio performance for its more than 600 institutional-client VC investors, reported an overall loss of 11% in 2003 for all VC funds, and a loss of 47% for 2001-2003 — a result of the bursting Internet bubble.

The Cambridge and Sand Hill Index data, however, don't present an apples-to-apples comparison. Cambridge looks at actual reported returns, while Sand Hill looks at the estimated value of companies in the portfolio.

So, Sand Hill is more of a forward look of what future returns might be. And the index says that future looks good.

Woodward says VC firms have been writing off bad bubble investments over the past two years. That explains why the returns posted by Cambridge in the past few years are so negative. But VC firms have cleaned out their portfolios, especially in the past year.

"What this suggests is the returns in 2004 will be fabulous," Woodward said.