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SPECIAL REPORT

Venture capitalists

From leafy to lofty

Venture capital is adapting itself to the new startup landscape

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TECH MONEYMEN LIKE altitude. In Silicon Valley the leading venture-capital firms cluster on a leafy hill overlooking Stanford University. And when Benchmark Capital opened a branch in San Francisco, it moved into the top floor of the Warfield building, home to a popular music venue. Although it is in the Tenderloin, one of the city's seediest districts, it offers a great view of the South of Market area, a breeding-ground for startups.

The bird's eye view may be similar, but the landscape beneath is shifting. For a start, the internet has democratised not only the founding of startups but their funding as well. When Naval Ravikant wanted to raise $8m for Epinions in 1999 (see article), he went straight to Benchmark Capital and other venture-capital firms on and around Sand Hill Road in Silicon Valley. But because starting up has become so cheap, today's founders have plenty of other choices, at least in the early stages: their own bank accounts, friends and family, accelerators, angel investors and—the latest addition— crowdfunding sites that allow startups to raise money directly from the general public.

Second, thanks to websites such as AngelList, startup financing has become more transparent. Originally a social network for startups and investors, AngelList is now also a funding exchange. As of early December its 24,000 accredited investors (people with a net worth of more than $1m or income of more than $200,000 a year) between them had put $250m into more than 1,000 startups of the total of 85,000 listed on the site.

Lastly, venture-capital firms are no longer seen as God-like. Some experts now claim that most of them are actually not that good at what they do. "Venture capital has delivered poor returns for more than a decade," concluded a 2012 report by the Ewing Marion Kauffman Foundation, a charity that supports entrepreneurship. And contrary to public perception, says Diane Mulcahy, one of the authors, venture capitalists (VCs) do not take a lot of risk. In most funds the partners' own money accounts for only about 1% of total capital. Annual fees of around 2% provide them with a comfortable income even if their investments do not make money.

VCs will continue to play an important, if smaller, role in channelling money to startups, says Ms Mulcahy, but many weaker funds will not survive. The number of actively investing VC firms in America has already dropped from 627 in 2007 to 522 in 2012, according to the National Venture Capital Association. At the same increasing difficulty of raising a first round of venture capital after the seed funding from angels and other sources. There is not enough serious money to go around for the proliferating number of startups.

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Times are changing on Sand Hill Road, too. Andreessen Horowitz, launched in 2009, has shaken things up by employing dozens of experts who help portfolio companies with everything from recruiting to public relations. And because startups now need less seed money, some firms have moved up the funding stack, focusing on later-stage rounds. But venture capitalists in the big league remain comfortable. In fact, thanks to the entrepreneurial explosion, they are enjoying a much bigger deal flow, says Bill Gurley of Benchmark in his lofty new quarters in San Francisco.

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