

# It's a good time to be an entrepreneur

## Commentary: The upside and downside of an overhang

By [Bambi Francisco](#), *CBS.MarketWatch.com*  
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### **SAN FRANCISCO (CBS.MW) -- Get your napkins out**

Venture capitalists who've enjoyed the stock market gains last year are increasingly amenable to paying small fortunes to entrepreneurs with good ideas.

Yes, it's a good time to be an entrepreneur, even if your business plan is written on a flimsy piece of paper.

Here's why. Venture capitalists are faced with an abundance of capital raised in 1999 and 2000 that have to be spent in the next couple of years.

The estimations for the dollar overhang are practically as wide as the varying projections for the government's Medicare reform bill. The most conservative estimation of the excess venture capital from the heyday is \$13.5 billion, as calculated by Keith Benjamin of Levensohn Venture Partners.

Even that, some say, however, is too much money to be absorbed.

If venture capitalists don't invest the overhang of funds they were entrusted with five years ago and paid to manage, they risk having to give back management fees to their investors.

To prevent that from happening, venture capitalists have incentive to invest across the spectrum - from tiny two-to-three man start-ups to later-stage ones on the cusp of profitability.

The good news for venture investors is that the public market bottleneck has eased. A total of 31 IPOs have raised \$8.1 billion in proceeds so far in 2004, well ahead of the five IPOs that raised \$645 million in the year-ago period, according to Thomson Financial.

The upside for the rest of us may be more jobs.

Similar to the concept of trickle-down economics (lower taxes to the rich who in turn create jobs that help the poor little guy), if larger venture capitalists can make money, since they can finally unload some investments to the public market, then their positive returns will trickle down to the little guys. In other words, one upside to the renewed financing activity in the private sector is that jobs may be created for the countless many still seeking work. (Of course, job seekers may have to move to India or China. But that's another story.)

Indeed, the number of start-ups getting seed to first-round funding in the fourth quarter jumped to 30 percent of all funds invested, according to VentureOne. These investments had been declining since accounting for half of all funds invested back in 2000.

The final quarter of last year marked a positive turnaround in this investment category.

"The entrepreneurs are coming off the beach," observed Geoff Yang, a Redpoint Ventures partner who looks at start-ups at the earliest stages.

See related venture story: [Post-bubble venture capitalists](#).

### Who's attracting money?

Despite the excess cash that's contributing to some investment decisions, it doesn't negate the fact that there are start-ups that are creating value.

Additionally, if history is any precedent, the best tech stocks may have been born during or after the recent bust.

See related story from 2002: [Why the best tech stocks may not be born](#).

So, what are the venture capitalists looking at?

Yang, who invested early on in companies like Ask Jeeves ([ASKJ: news, chart, profile](#)) and Tivo ([TIVO: news, chart, profile](#)), is most interested in companies that help advertisers circumvent the advertising-zapping capabilities of digital video recorders in order to impose themselves upon the consumer. I know what you're saying: What's he thinking? He should have stopped at Tivo -- which appears to be saving us from irritable ads, at least temporarily.

Rest assured, however, Yang has yet to find an advertising start-up with such a solution. But he did invest in Everest Technologies in hopes that the advertising start-up will one day stumble upon a viable solution for this particularly advertiser's quandary. For the moment, Everest is one of the hundreds of companies that help advertisers maximize their online search campaigns from the leading sites from Yahoo ([YHOO: news, chart, profile](#)), Google, Microsoft's ([MSFT: news, chart, profile](#)) MSN, Time Warner's ([TWX: news, chart, profile](#)) AOL, InfoSpace ([INSP: news, chart, profile](#)), Ask Jeeves to eBay ([EBAY: news, chart, profile](#)) to Inspiringaudiencemagnet.com.

It is in the search and advertising industry where a number of new investments are being made to, quite simply, help advertisers get the most bang for an online buck.

Kanoodle unveiled a new tool on Monday for advertisers to measure the effectiveness of their advertisements appearing on articles, or elsewhere besides a search results page. It received funding in December of last year.

Levensohn Venture Partners announced Monday that it completed an \$8 million round in Informative, a brand-marketing company with a specialty in online surveying. Mark Goldstein, a veteran entrepreneur in the retail and technology industry, recently raised funds for his latest venture, Instorecard.com, which currently has 15 employees.

Venture capitalists aren't just putting money to work in companies building businesses off the existing platforms created by the portals.

They're also placing bets on the platforms created by auction companies, like eBay. In February, the online marketplace operator along with venture capitalists invested in Channel Advisors, a start-up to help liquidators sell their wares off of online auction and retail stores.

Online music services and stores, launched by a plethora of newcomers but pioneered by the likes of RealNetworks ([RNWK: news, chart, profile](#)) and Apple Computer's iTunes ([AAPL: news, chart, profile](#)), are also seeing entrepreneurs layer their business ideas on top of such platforms.

WaldenVC, a San Francisco venture firm, invested in Savage [Beast](#), a start-up helping music retailers sell more digital music. Savage Beast breaks down a song to hundreds of

characteristics, in order for retailers to have more options to recommend songs to a potential customer. The founder calls his project the music genome project, a take off of the human genome project, an effort to identify the thousands of genes in human DNA.

### **The downside of an overhang**

On one hand, I am encouraged that entrepreneurs, like 24-year-old Sean Parker, who co-founded Napster, and more recently Plaxo, a start-up which received funding in February 2001, now operate in a more receptive environment where they can see their ideas come to some sort of fruition.

On the other, I am concerned that we may see a return of the trendy vanguard armed with inflated egos and misguided motives in pursuit of an IPO, even though others don't see it.

"Entrepreneurs are coming back because of passion," said Peter Barris, managing general partner at New Enterprise Associates, which just raised \$1.1 billion this past February. The funds invested will be as little as a few hundred thousand to more than \$50 million.

While I believe there is some truth to that, money has a way of changing every good intention.

What's more, the excess venture capital dollars, or overhang, that's being put to work to fund entrepreneurs may lead to ever-rising unwarranted valuations that end up blowing up in someone's face one day in the future.

Look at the new IPOs from China, like Tom Online ([TOMO: news, chart, profile](#)) and Linktone ([LTON: news, chart, profile](#)). Both IPOs are trading below their public offering price to the upset of many public owners. China's Semiconductor Manufacturing International Corp. ([SMI: news, chart, profile](#)) was the largest technology IPO to hit the market this year. Its shares also fell below the IPO price.

"I don't think it [overhang] can be absorbed," said Bill Tai, a partner at Charles River Ventures, suggesting that there are a limited number of investments venture capitalists can make in a year.

To this end, more money flows into fewer ideas, potentially sending valuations way ahead of fundamentals.

At the moment, the price inflation seems to be more apparent in later-stage investments where there is more certainty about business models, and therefore more competition for those investments.

Price inflation at later rounds may eventually reach Joe public investor, who will be the unfortunate soul holding a bag of overpriced stocks.

This is precisely what could come to pass if venture investors recklessly bid up for investments.

So while it's a wonderful time for entrepreneurs to push for their ideas, it's also a time for venture investors to exercise restraint.

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Bambi Francisco is Internet editor of CBS.MarketWatch.com, based in San Francisco