Comments of Thomas C. Melzer,
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"Venture Capital and the Internet Bubble:
Facts, Fundamentals and Food for Thought"
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I am pleased to have the opportunity to discuss "Venture Capital and the Internet Bubble: Facts, Fundamentals and Food for Thought" and be together with former Federal Reserve colleagues and others interested in venture capital.

I left the Fed in early 1998. As is customary, the Federal Open Market Committee held a farewell luncheon for me following its meeting in December 1997. Also by custom, following the luncheon there are remarks—some serious, many in jest—by various individuals, including the departing member. A part of my remarks was a "Top Ten List" of reasons why I was leaving the Fed. One of them was, "To join a hedge fund so that I could have an influence on interest rates." Don't ask whether that was in the serious or jesting category!

Well, I didn't join a hedge fund, but in 2000 I did start, along with three other partners and co-founders, a venture capital fund focused on early stage healthcare investing. Perhaps, in Dr. Hellmann's words, I was just another one of those people from all walks of life who discovered his innate venture capital ability. I hope not, but be that as it may, I have transitioned from being an observer of the economy at 30,000 feet to a player absolutely at ground level. Today, when I describe my background to entrepreneurs or other venture capitalists, I often say, sometimes even with a straight face, that the Federal Reserve System is a great entrepreneurial training ground. Most of them laugh, and indeed that was what I intended.

But again, just as in my Top Ten List remark, there can be a fine line between what is jesting and what is serious. In fact, the structure of the Fed System, with its quasi-private regional Reserve Banks, overseen and politically accountable through the Board of Governors in Washington, provides a ripe opportunity for innovation in carrying out the System's mission. This opportunity is reinforced through local governance by diverse boards of directors drawn from the private sector in the various regions.

Furthermore, the regional structure facilitates staying in touch with what is going on in the economy at a grass roots level. For today's purposes, that is the important point, and I applaud the Atlanta Fed and the Stern School for hosting this conference to increase the knowledge of all of us about the venture capital industry. Now, I could jest again and say that if Fed economists are broadly interested in venture capital, then the ball game must be about over, but I don't want to contemplate that possibility for obvious reasons.

I would like to make several observations prompted by the paper. First, the venture capital bubble did not occur in all sectors, notably healthcare. In fact, the bursting of the IT/telecom bubble may have had a beneficial impact on healthcare venture investing. While the bubble was still expanding, healthcare partners in diversified venture firms had a hard time getting their deals done. The potential of these deals, with their attendant regulatory and reimbursement risks, simply couldn't stack up to the large multiples and short paths to liquidity that the IT/telecom deals seemed to promise.

From late 1998 through early 2000, many diversified firms got out of healthcare investing altogether, while others simply curtailed their activity. As a result, a number of experienced healthcare venture investors were moving around at that time, either forming new venture firms focused on healthcare investing or joining established healthcare firms. I suspect this movement led to greater industry specialization by sector, which makes sense given the increasing technical complexities and unique operating characteristics of each sector, including healthcare.

For us, it provided the opportunity to put together a nationally-focused healthcare venture firm based in St. Louis, with two partners and co-founders experienced in venture capital. One came from a Minneapolis firm that got out of healthcare investing completely, and the other, from the New York office of a Chicago firm that reduced its commitment to the sector. And despite renewed interest in healthcare venture investing after the IT/telecom collapse, private valuations remain attractive. Of course, bubble or not, all venture capital sectors are being negatively affected by the current general lack of IPO exit opportunities.

My second observation relates to the renewed interest in healthcare venture investing. The potential certainly exists for repeating some of the same mistakes that occurred in the IT/telecom bubble, inasmuch as investing capacity is limited. Should institutional investors want to increase their commitments to the healthcare sector significantly, the most likely outcome would be much larger funds under the management of experienced venture groups. In his paper, Thomas has pointed out the possible consequences of a dramatic upward shift in capital under management: (i) doing more deals than can properly be supported by existing investment staff; (ii) putting more capital at risk in a single deal than is prudent; (iii) and moving up the “food chain” to larger, later stage deals, perhaps compromising the future later stage pipeline. Indeed, a galvanizing factor in the formation of RiverVest was the recognition that the market for early stage healthcare venture investments was under-served.

I suspect, however, in light of the recent IT/telecom experience, that institutional investors will be more circumspect about these risks for some time. Furthermore, because of the dismal performance of public markets in recent years, many investors find themselves over-allocated to private equity, including venture capital. Unfortunately, ongoing write-downs in private equity portfolios may bring these allocations more into line in a not-so-pleasing way. In any case, these investors don’t have a lot of available capital to invest in private equity and are generally trying to reduce rather than add to their relationships. Therefore, new capital flows into the healthcare sector are likely to be gradual and of relatively modest proportions, at least in the near term.

Third, I would like to comment on Thomas’ passing reference to the lack of transparency and the need for credible governance structures in the venture industry. I would encourage him to develop these thoughts more fully.

My view is that limited partners in venture funds are sophisticated investors who should be able to make informed decisions without elaborate governance structures (read in the extreme to mean government regulations). Many employ consultants, or “gate keepers,” to source and evaluate fund investment opportunities. One of these consultants that I am familiar with, a leader in the field, has extensive performance data on a vintage-year basis by sector and does in-depth due diligence reports on recommended funds. If there is a flaw in this approach, it is that it relies on past performance as an indicator of the future, but it is very rigorous. Should a fund's track record, the due diligence, the fund size in relation to staffing, or the deal structure be unsatisfactory, the investor can just say no. How is some sort of industry governance structure going to beat that?

Clearly, during the IT/telecom bubble, limited partners who wanted to maintain or establish relationships with proven fund players may have been reluctant to just say no, despite large fund size in relation to staffing and/or "stiff" terms. But whom do they have to blame but themselves for poor outcomes today? And even in markets arguably with much greater transparency and credible governance structures (i.e., public securities markets), a bubble developed in the late 1990s. And the idea that venture capital should be conducted through public vehicles, although some exist, doesn't make any sense to me, nor I suspect to Thomas. The uneven nature of venture funds' return profiles over time just doesn't fit what investors in public companies are typically looking for, including predictable growth in income over time.

Finally, I do not think, in the case of many venture funds, the incentive structure is skewed, particularly for first-time funds, which are very difficult to put together on a scale at which the economics work. This issue should be viewed in the same way that Thomas looks at the performance data—on a long-term basis versus a short-term one during and immediately after the bubble. For, say, a $100 million fund, which was likely a reasonably large fund pre-bubble, the principal incentive to the general partner is clearly the carry, not the management fee. And, for a first-time fund, the incentive to perform is even greater. In the absence of good performance, the first fund is likely to be the last.

In sum, with the couple of caveats I have stated, I applaud Thomas' work that seeks to evaluate the fundamental value added by venture capitalists, as well as his desire to explore the evolving industry structure.

Thank you.