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VC firms rethink their strategies Industry veterans say funds must avoid being caught in the middle, says Kevin Allison

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By KEVIN ALLISON

Venture capitalists are scrambling to reassess their business models as a glut of capital, a weak market for initial public offerings and changes brought about by globalisation combine to create a "perfect storm" that is sweeping the industry.

The difficult environment has led some venture capitalists to leave the business. Others are moving from their old firms to form new ones.

As the Silicon Valley venture scene enters a new period of change, some VC veterans argue that there are two options available to firms that want to rise above the rest: become big and global or become small and focused. Just do not get caught in the middle.

"The day of the provincial, isolated venture fund is coming to an end," says Timothy Draper, a founding partner of Draper Fisher Jurvetson.

In the late 1990s, DFJ was among the first Valley VCs to break free from the industry's fixation on Silicon Valley and a handful of other US innovation hotspots, such as Boston and Austin.

In 1999, it opened offices in Beijing, Hong Kong, London and Singapore.

In the years since, some of DFJ's biggest hits have come from overseas.

They include Skype, the European voice over internet protocol company bought by Ebay for Dollars 2.3bn last year; and Baidu, the Chinese internet portal that went public on the Nasdaq Stock Market last year.

DFJ also operates a network of affiliated funds designed to increase its exposure to good ideas.

"We don't only share deal flow with the network but we share contacts, introductions and we syndicate," says Mr Draper. "The entrepreneurs that any firm in the network funds have the support of the whole network."

But this "big and global" approach comes at a cost. "We try to keep it simple, and each country we work with gets more and more venture capital and entrepreneur friendly, but still there are some serious administrative and other costs to doing business overseas," says Mr Draper.

The hardest part is finding good people. "People have to be local," says Steve Jurvetson, another DFJ partner. "You have to grow them indigenously or take (people who have returned to their home countries)."

Other firms are also expanding internationally. Sequoia Capital, whose successful investments include Google, YouTube and Oracle, boasts offices in India, China and Israel.

"Technological innovation abroad has been there for a long time," says John Balen, a partner at Canaan Partners, which established offices in India and Israel this year. "Because of the internet, it's easier to work overseas than ever before."

Expanding abroad may work for the bigger, more experienced firms whose brand recognition allows them to recruit new partners overseas. Some VC firms with less scale and brand cachet have elected to take a different approach.

When Brian Jacobs, Gordon Ritter and Jason Green formed Emergence Capital Partners in 2002, they decided to keep their fund small and focus most of their investments in a single market niche. "Our strength is our focus, and being known for having real expertise in a particular area," says Mr Jacobs.

For Emergence, that area was "software as a service" - a growing industry that is taking on big software vendors such as Oracle and SAP by offering customers the ability to outsource non-core business processes such as sales or human resources management.

Mr Jacobs and his partners acknowledge that their strategy is risky. Some VC firms that made tightly focused bets during the dotcom bubble - such as those that backed business-to-business exchanges - got burned.

But Mr Jacobs says Emergence's focus has led to a greater number of opportunities coming across his desk. "We are seeing 60 to 70 per cent of the deal in this space," he says.

Emergence raised Dollars 125m for its first fund. Even though it has yet to produce a big exit, excitement about software as a service has led some investors to press the firm to raise a bigger fund in six to nine months.

"We have to keep looking each other in the eye and saying 'we don't want to do that, right?' There is a huge financial incentive, and there are very prestigious investors who don't like to hear no for an answer," says Mr Jacobs.

But outsized funds are what have led many VC firms to stumble in recent years as venture capitalists struggle to put all their investors' money to work.

"If we hadn't seen that movie before, I would do it," Mr Jacobs says.