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It's Not As Easy As It Looks

What would you do if someone handed you, say, $220 million and told you to invest the money in healthcare opportunities?

That's exactly what happened to Allen Frazier in 1998. Frazier is the founder and managing partner of Frazier Healthcare Ventures, based in Seattle. Since 1991, he has raised $750 million to capitalize five private equity funds, all exclusively investing in healthcare ventures.

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The third Fund, Frazier Healthcare III, was raised in 1998 at the height of the go-go boom and had initial capital of $220 million.

Since then, Frazier and his partners have invested in an undisclosed number of companies in four healthcare sectors: Biotech, Medical Devices, Healthcare Services, and Healthcare Information Technology.

So how has he done? Not so hot.

Through June 30 of last year, the most recent date for which information is available, FH III had returned a NEGATIVE internal rate of return to its limited partners of 10.7 percent annually.

But before you begin to think Allen Frazier is not very good at picking companies, consider that Frazier's returns for his late 90s fund are actually pretty good when you look at what others have done. Other big-name Funds have returned anywhere from negative 1.0 percent IRR to negative 62.0 percent IRR. That's an ANNUAL compounded loss of 62 percent each year since that fund (Telecom Partners III) was founded in 1999.

The Deal, a venture capital industry publication that studies such things, recently listed 22 funds formed in the late 90s that are "underwater." This means that their funds have negative returns to date.

What happened?

A lot happened, of course. A recession broke out just when things were really getting hot. A terrorist attack or two caused more than a little concern in the markets. The stock market decided to do a correction. A war — actually two wars — happened. And all of this just snowballed for almost four years.

Companies into which fund managers had invested had a hard time making their projections. The funds had to pump more money into these struggling portfolio companies to keep them afloat and buy time for things to improve. The market correction effectively foreclosed the IPO market, ending exits. Banks got very stingy with their lending standards, as they always do in recessions, and this effectively dried up mergers and acquisition activities, another source of exits for fund managers.

The news was not very good at all for the last few years.

Last year saw some reason for more optimism, however, as the recession gave way to GDP growth. The stock market rebounded. Profits are rising, even among newer startups. The banks are looking for deals aggressively. All in all, things appear much better as we enter 2004.

But, if you are an entrepreneur, don't assume this means a return to the heady days of the late 90s when money was raised in bushel baskets over power breakfasts.

With many funds underwater, or certainly performing at levels less than expected, it's harder to raise new funds from limited partners like endowments and pension funds. Many fund managers are still more focused on solving yesterday's problems than finding new deals.

Many funds, whether they will admit it or not, just simply do not have any liquidity to make new investments. And many late 90s funds are now nearing the mid-point of their typical 10-year life so even if a good deal is found, there may not be enough time to invest and expect an exit within five years.

Here is what you should do if you are an entrepreneur and want to raise funds for a new venture:

• Fund the business plan and proof of concept stage yourself. Raising this money is almost impossible.

• Design your plan to get to cash flow breakeven as soon as humanly possible. Everything changes when you begin to make even a little bit of money. Just don't burn it, at all costs.

• Instead of starting a business from scratch, find an existing platform of some kind and try to grow that. Selling an investor on a deal that has existing revenues is a lot easier than funding a blank slate.

• Try to fill your acquisition pipeline with deals that can be closed upon funding. The fund managers are lining up these days to invest in these types of transactions.

As always, the rules change just when the crowd shows up. The rules are going to be different in the 00s versus those we were accustomed to in the 90s. Get used to it.

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