

High Growth Entrepreneurship in Texas: Entering a Vicious Cycle

By Stephen Straus

***Abstract:** Texas is facing a decrease in the availability of early-stage venture capital. Aggressive efforts are needed to grow state-level resources to reverse this downward spiral.*

Texas is entering a vicious cycle - one that threatens to undo the enormous efforts that have gone into building Texas as a vibrant center for high growth entrepreneurialism over the past several decades. If we don't take immediate action, Texas could be permanently out of the game.

Venture Capital Is a Major Driver of the Texas Economy

Why play? Venture capital boosts both America's and Texas' economic strength and creates jobs. In 2003, venture capital-backed companies employed more than 10 million American workers and generated \$1.8 trillion in sales. Texas ranked second by employment with venture-backed companies headquartered in the state with almost 900,000 employees. Texas was also second, behind California, in revenue by Texas headquartered VC-backed firms with \$188 Billion.ⁱ

Texas appears to have all the ingredients for high growth advanced technology entrepreneurship. We have plenty of capital in large public and private institutions, oil money and wealthy individuals. We have the second highest number of IT workers in the USⁱⁱ. We have the third largest State economy after California and New York, and in fact would rank as the eighth largest country in the worldⁱⁱⁱ. Texas is a major center for both corporate and university R&D and we've developed a robust entrepreneurial ecosystem. And finally, Texas is formally embracing company formation and entrepreneurship as an economic development strategy through such public policy initiatives as the \$200M Emerging Technology Fund.

Texas is Losing Its Standing as a Major Center for Venture Capital

It wasn't always this way. The venture capital industry has its roots in California, which has enjoyed more than five decades of prosperity driven by the venture industry. Texas, by contrast, didn't hit critical mass in venture capital (fueled by high technology entrepreneurialism) until the 1990s. Unfortunately, Texas has not recovered from the bursting of the stock market "Bubble" like other areas have. This year we will likely lose our standing to Washington State as the third largest venture capital market in the country behind California and Massachusetts, a ranking we've held for over twenty years. Without taking some measure of corrective action, we're likely to drop farther down the rankings in the coming years.

Other challenges exist - entrepreneurship is increasingly difficult, and entrepreneurs are finding that the venture capital fund raising process is long and offers limited options. Additionally, many of the Texas-based venture capital firms have either disbanded or are having a difficult time raising additional investment capital. To compound the problem, new venture funds are not being created. The Angel community, wealthy individuals

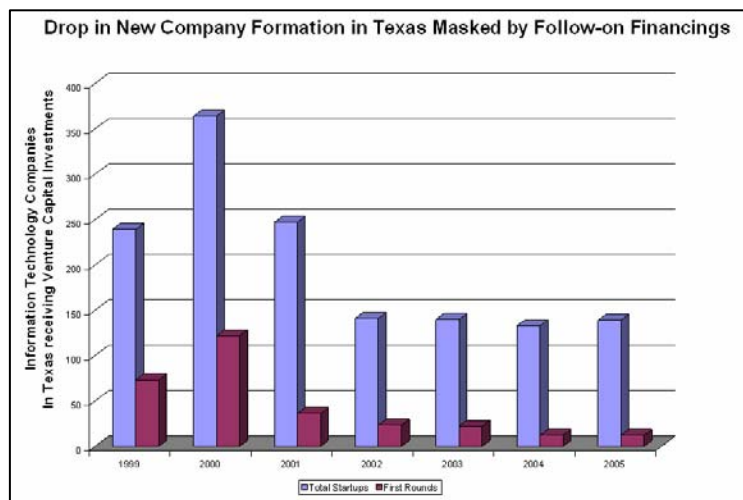
who invest early in the company formation process, has largely dried up in Texas as well. The net result is that Texas is experiencing a “brain drain” as experienced entrepreneurs, engineers and senior management leave for more vibrant areas.

The problem is not a lack of opportunity. As stated above, for at least 20 years, Texas has consistently ranked as the third largest Venture Capital market with over \$16 Billion invested in the state. Plus, over the same time period, Texas has imported 70% to 90% of its capital from firms not based in Texas.^{iv} However, that imported capital typically follows Texas-based venture capital firms that find and lead investments. Given the substantial decrease in the size and number of venture capital firms in Texas, we can expect substantially less capital to be imported over the coming years, even if the percentage of imported capital stays the same.

Why aren't market forces working to address the opportunity? There are several compounding problems. First, most people aren't aware of the severity of the problem. The danger is hidden by the large number of companies in Texas funded during the Bubble era that are still raising follow-on rounds of financing each year. These investments ‘mask’ the substantially decreased underlying rate of VC investment in new company formation in Texas.

Almost None of the Venture Capital in Texas Today is Going to New Companies

The percentage of new information technology companies backed by venture capital firms out of the total investments in the State is down 60% from 1996 to 2005. Another way of looking at the same data is that only eight percent of the information technology companies funded by venture capital firms in Texas in 2005 were early stage companies receiving their first round of financing.^v Without significant change, it is painfully clear that we will wake up soon to headlines saying Texas has lost its standing as a major center for venture capital activity.



Source: National Venture Capital Association and Venture Economics, a division of Thomson Financial

It would be unwise to look for out of state capital to take advantage of this opportunity. Most venture capital funds won't invest in a company without a local lead investor. Since it is very difficult to fly to a company to address big problems without robust local support, the venture capital industry has found that opening remote offices is difficult. Venture capital funds that do plan any type of geographic expansion appear to be focused on very high growth market opportunities like China and India.

Venture Capital in Texas Represents a Major Opportunity

So the challenge is quite clear. What aren't as clear are the best solutions. Given that venture capital returns have substantially outperformed the NASDAQ and S&P 500 over the past three, five and twenty year periods^{vi} it makes sense that market-based solutions can be found. I suggest that to recover our vibrant venture capital community, we should focus on two key ingredients. The first and foremost is people. Both institutional investors and wealthy individuals look to back teams with substantial investing experience and track records who can deliver superior returns. The second ingredient is Texas based capital. There is substantial capital in Texas, but very little is looking to take advantage of this profound opportunity. It appears that no institutional investors have a mandate to invest their capital in Texas, and some even explicitly shy away from it to avoid even the appearance of favoritism. Wealthy individuals have also been avoiding this investment opportunity, in part due to wariness over their lack of familiarity with the way the technology sector works. And, those individuals who did invest in venture capital in the late 1990s appear to be feeling "once burned, twice shy."

The resulting Texas phenomena stands in stark contrast to investors in Silicon Valley, who understand that the venture capital markets are historically cyclical, and have jumped back into the market with both feet since the early part of this decade.

The public sector could kick start this engine of economic development as well. A fund similar to the Emerging Technology Fund could be created to invest either directly in venture capital firms, or even better, in a Fund-of-Funds run by managers with experience in picking top venture capital funds. As a first step, the Leadership should encourage institutional investors to diversify a small fraction of their portfolios and invest Texas dollars in Texas based company growth.

In summary, the opportunity for investing in venture capital in Texas is profound and real. Texas needs both credible teams and Texas based capital to coalesce around this opportunity, or it risks continuing the vicious cycle the state has entered, a vicious cycle that if left unchecked will lead to the loss of our standing as a leading State for high growth entrepreneurialism.

Stephen Straus joined Austin Ventures in 1996 as a Kauffman Fellow and was promoted to General Partner in 2000. At the beginning of 2005, Stephen left Austin Ventures to launch an early-stage technology venture capital firm focused on Texas.

Prior to Austin Ventures, Stephen was founder of the Solutions Group in Washington,

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ⁱ National Venture Capital Association's Venture Impact report published in 2004

ⁱⁱ American Electronics Association Cyberstates 2006 report

ⁱⁱⁱ Texas Economic Update, office of Texas Comptroller Carole Keeton Strayhorn

^{iv} National Venture Capital Association and Venture Economics, a division of Thomson Financial

^v Ibid

^{vi} Ibid