

## **Venture Capital Exits Mirror Overall Economic Woes**

By Tomio Geron 10/1/2008

Against the backdrop of an historic financial crisis, the venture capital industry's liquidity problems are mounting.

According to new data from Dow Jones VentureSource, mergers and acquisitions activity and initial public offerings of venture-backed companies are on pace this year to hit their lowest point this decade. During the third quarter, venture-backed companies produced just \$4.57 billion through IPOs and M&A, down 66% from the \$13.4 billion generated in the year-ago period.

The IPO market continues to be shut off for venture-backed companies, as only Rackspace Hosting Inc. went public in the third quarter, compared with 11 such offerings a year ago. Meanwhile, 66 M&A deals involving venture-backed companies generated \$4.4 billion, compared with 116 deals and \$12.7 billion a year earlier.

The numbers look even worse year-to-date. Only seven venture-backed companies have gone public so far this year, compared with 48 in the first three quarters of 2007. The lack of IPOs is more pronounced now than during the dot-com bust earlier this decade, when 13 venture-backed companies went public in the first three quarters of 2001 and 14 venture-backed firms went public in the first three quarters of 2002.

What's more, just 247 venture-backed companies were bought by acquirers during the first three quarters of this year, generating \$22.3 billion, down from 327 and \$34.1 billion in the same period last year, according to VentureSource, which is owned by Dow Jones & Co. publisher of VentureWire. That means 2008 is on pace to see the lowest amount of M&A deals this decade; the previous low was in 2003, when there were 359 deals that produced \$13.2 billion. The number of deals has fallen for four straight quarters, while the value has dropped the past five.

Sector-wise there were no bright spots. The number of information technology exits, which includes software, communications and semiconductors, took a dive in the third quarter to 48 deals from 74 deals in the year-ago period. More telling, the total exit dollars in IT was \$2.9 billion, down 60.3% from \$7.3 billion in the third quarter last year, suggesting acquirers are cutting back on spending. Year-to-date, 170 IT companies were acquired for \$12.8 billion, versus 207 companies and \$17.9 billion a year ago.

Health care fared poorly as well. Eleven companies were acquired for a total value of \$798 million, compared with \$2.5 billion from 15 deals in the third quarter of 2007. Year-to-date, 38 companies were acquired for \$2.9 billion, compared with 43 companies for \$6.5 billion.

Another sector separated out by VentureSource, the business and financial services category, which had been gaining steam the past couple of years, showed little signs of life in the third quarter. Just three companies produced \$160.8 million, compared with 22 companies and \$2.4 billion a year ago. Deals for the year-to-date period fell to 28 from 49, while the total value actually rose to \$5.6 billion from \$5.2 billion due to a strong showing in the first quarter this year.

### **Buyers Be Wary**

As companies wait around for exit options, the median time between a start-up company raising its first round of funding and generating an exit for investors now sits at about 6.1 years. This has created an excess of mature companies that have little place to go. For instance, more than 1,200 companies originally funded in 1999 and 2000 still sit in venture firm's portfolios, according to VentureSource.

Investors say that large companies that typically do acquisitions are taking a wait-and-see approach to their normal deal making.

"What I hear is, 'We're still interested. Let us get back to you,'" said Bob Ackerman, managing director at Allegis Capital. "When you probe deeper, it's, 'We're going through an internal exercise to recalibrate ourselves.'"

That recalibration involves reviewing every aspect of a business in times of uncertainty. Rather than acquiring, some large companies may be more interested now in spinning off entities that do not fit their core businesses, Ackerman said.

On the health care side, some venture investors blamed a tightening regulatory environment that is making it more difficult to get new medical products approved. That's injecting caution into corporate acquirers, especially in the medical-device field, said Leslie Bottorff, general partner of Onset Ventures. And medical device manufacturers can afford to approach M&A more deliberately because one of the most aggressive consolidators traditionally, Boston Scientific Corp., has been less active since it swallowed Guidant Corp. in 2006, she said.

Yet large device and drug companies still rely on acquisitions for growth, so some see the third quarter as an aberration that will be corrected as the economy stabilizes. "I can't explain the data, but I absolutely think the trend is for more M&A," said Steven St. Peter, managing director of MPM Capital.

Further hurting the cause for the overall venture industry, M&A deals have become increasingly difficult due to credit problems. If an acquiring company wants to buy using debt, such credit is much more expensive now. "Trying to secure credit for acquisitions may be harder to do or impossible now," said Lou Bock, managing director at Scale Venture Partners.

On the other hand, if the company really wants to make a deal, they may have to dip into precious cash reserves or try to convince venture investors to take stock despite violent market volatility, Bock added.

**The longer trouble lingers, VCs will be forced to flex their creativity in order to bring in cash. Pascal Levensohn, founder of early-stage technology investor Levensohn Venture Partners, expects to see more mergers involving two venture-backed companies in order to give them public-market appeal. Investors may also have to look to sell their stakes to secondary firms or larger private equity firms that can prop these companies up for another few years.**

Valuations Headed South

With the IPO market plugged up, acquirers hold an advantage in their negotiations with start-ups which have no other place to go. Valuations, therefore, have been affected for start-ups seeking an exit, especially on the later stage, where companies are more easily compared with public companies. The median amount paid for a venture-backed company in the third quarter was \$49 million, down 46% from \$90 million last year.

"Valuations have come down, but they've been down for a while," said Al Waxman, senior managing member at healthcare investor Psilos Group. "It's much more rational now."

For some venture firms, this means saying no to a deal in a buyers' market in hopes of recouping a larger return when markets improve.

"We had somebody approach us about one of our companies, which is profitable," Waxman said. "But they didn't want to pay us what we thought we should get. We think its market prospects are good and we'd rather let it grow further."

Ultimately, venture investors may hold off on putting money into new companies in favor of continuing to nurture their existing investments. That could crimp innovation coming out of venture capital centers such as Silicon Valley. But early-stage investors say there's plenty of opportunity in times like this to invest in unique products and team at cheap prices.

"You want to have something people really need that's relatively unique," said Dan Ahn, managing director at early stage firm Voyager Capital. "That need doesn't go away with market softness. It's just an issue of price."

-With reporting by Brian Gormley and Pui-Wing Tam