

IPO Spotlight: VCs See Fewer 2008 Deals

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Posted 24 December 2007 @ 11:10 am EST

Venture capitalists are bracing for fewer exits from portfolio companies in 2008, as both the initial public offering and merger-and-acquisition markets are expected to wane.

The consensus seems to be that fewer venture-backed IPOs will be completed next year, but their overall values will rise, while more mergers and acquisitions will be completed but at a much lower value.

Don Caldwell, founder of Radnor, Pa.-based Cross Atlantic Capital Partners, has been working hard to exit companies now because he expects fewer opportunities next year. "I know it's not the most rosy picture, but it's really the way we're functioning," he said. "I think that's inevitable of a slowing economy." Cross Atlantic exited seven companies in 2007, two through IPOs and five through M&As.

The IPO market was fairly healthy in 2007, with 80 venture-backed IPOs completed year-to-date, according to the National Venture Capital Association, compared with 57 total deals in 2006. Venture-backed M&As through the first nine months of 2007 totaled 229, compared with 340 total in 2006, according to the NVCA.

In a recent survey of more than 170 venture capitalists by the NVCA, 59 percent of all respondents said the venture-backed IPO market will see further recovery in 2008, but 44 percent of those respondents predict that recovery will be at the same or slower pace than in 2007. Nineteen percent of total respondents predict the market will weaken.

Fifty-five percent of those polled believe the transaction volume in venture-backed M&A market will increase, while only 35 percent expect the value of those deals to increase.

"There is such an oversupply of venture-backed startups that need to get acquired that it's a buyers market, and that necessarily lowers pricing," said Paul Maeder, a managing general partner at Highland Capital Partners, a VC firm based in Lexington, Mass.

Caldwell agrees that the value of M&A deals will likely decrease, but expects the value of IPO deals to climb.

"If the IPO market is weak, the only companies that get done are very strong companies," he said. And stronger companies mean higher valuations.

Perhaps the biggest change VCs have seen in their industry in the past few years is an increase in the time it takes to exit a company.

The exorbitant costs associated with becoming Sarbanes-Oxley compliant have prevented many small companies from going public, Maeder said. And as the economy slows, investors have shifted their interest from get-rich-quick schemes prevalent in the late 1990s to companies with proven financials.

"We used to take companies public that had \$20 million in revenue and four or five quarters of profit," Maeder said. Now, companies have to generate between \$50 million and \$70 million in revenue and be solidly profitable in order to go public, he said.

According to Greenwich, Conn.-based Renaissance Capital, 62 percent of the companies that went public this year were profitable. Comparatively, Kathy Smith, principal, says roughly 75 percent of the companies going public during the dot-com era were unprofitable.

The median time from initial equity funding to IPO has grown to 6.1 years in 2007, with \$71

million the median amount raised pre-IPO, according to a study by VentureSource, a venture-capital research database. This compares with 2.8 years and \$31 million in 1999 and 4.5 years and \$48 million in 2001.

Likewise, the median time from initial equity financing to an M&A exit has increased steadily over the last few years, with 6.5 years the median amount of time in 2007, compared with 2 years in 2001, 4.6 years in 2004, and 6 years in 2006. At the same time, the median amount raised before a merger or acquisition has grown to \$22 million, up from \$15 million in 2001 and \$20 million in 2004.

As a result, a secondary market has emerged for VCs. Ken Sawyer, managing director of San Francisco-based Saints Capital, has made a living on buying shares in companies from VCs looking to exit portfolio companies at a quicker pace. A similar secondary market has existed in the private equity world for some time, but the concept is fairly new to venture capital, Sawyer said. He's seen this alternative exit market grow exponentially since founding his firm in 2000.

"The emerging third form of liquidity doesn't affect traditional exit markets," he said. Rather, it adds value to the VC industry.

"You're much more likely to make an investment if you can get out of it the next day than if you can't," he said.

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