The exit slowdown and the new venture capital landscape*

Findings from the MoneyTree™ Report

A quarterly survey produced by PricewaterhouseCoopers and the National Venture Capital Association based on data provided by Thomson Reuters

*connectedthinking

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The heart of the matter

The shifting exit landscape

The proverbial IPO window lifts, falls, then lifts again. Veteran venture capitalists have lived through such cycles, but few have seen the window shut as completely as it did this year.

In the second quarter of 2008 there were zero VC-backed exits—on the heels of five in the previous quarter, which raised a thin $283 million. In the first half of 2007, by comparison, 43 VC-backed IPOs collected $6.3 billion. When the last VC-backed IPO shutout hit, in 1978, “Stayin’ Alive” topped the charts and Space Invaders ignited the video game market. The country was mired in recession and wading into its second oil crisis.

Nearly two months into Q3 2008, the window nudged open for two cleantech debuts—desalination company Energy Recovery and solar-cell equipment supplier GT Solar—suggesting that cleantech IPOs may very well lead an IPO recovery. When the window does reopen, it may reveal an altered VC landscape, one shaped partially by the exit slowdown. In the long term, the VC industry could likely be altered in three ways:

1. Bigger IPOs, but fewer of them

The exit slowdown will likely lengthen the VC-backed company life cycle, with VCs extending follow-on financing for later-stage companies that might otherwise have been ripe for exits. VCs will also be under greater pressure to grow IPO candidates big enough to succeed in a more rigorous and expensive IPO process. The next generation of VC-backed IPOs may well be more mature and battle-tested, and more apt to hit Wall Street’s sales and earnings targets.

2. Shift in VC investment focus

Bigger exits may ultimately translate into less lucrative investments, as VCs react to exit slumps by pouring more private funding into companies at high valuations—effectively raising their average costs. If the majority of exits do become less lucrative going forward, VCs may become less likely to invest in capital-intensive and longer-to-maturity start-ups.

3. VCs as incubators for strategic investment

The exit slump opens a window for strategic investors, and until the IPO window reopens, M&A deals will likely comprise an ever-larger piece of the VC exit pie. As a result, VCs may be positioned more as incubators for the strategic investors and less as an IPO pipeline. As acquirers strive to limit integration costs and maximize acquisitive earnings, VCs will be under more pressure to build companies able to achieve these goals. VC-backed companies that don’t may likely be the losers in this fast-shifting VC landscape.

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Jittery investors, an unstable credit market, and volatile equity markets conspired to potent effect in early 2008 to precipitate the exit slump.

An in-depth discussion

Looking for an exit

Jittery investors, an unstable credit market, and volatile equity markets conspired to potent effect in early 2008 to precipitate the exit slump. Only 5 VC-backed IPOs were priced in the first quarter of 2008, raising $283 million. By way of comparison, the first quarter of 2007 saw 18 VC-backed IPOs raising $2.2 billion. In the second quarter 2008, there were no IPOs of VC-backed companies whatsoever, representing the first complete IPO shutdown since 1978. Four of the five IPOs in the first half of 2008 were life science companies. Among these issues, the average amount raised was a modest $57 million, down from an average of $98 million in Q4 2007 and $121.7 million in Q1 2007.

The largest offering was California-based patient management provider IPC The Hospitalist Company, Inc., which raised $83 million. ArcSight, a security management provider, was the sole VC-backed information technology issue for the first half of 2008, valued at $62 million.

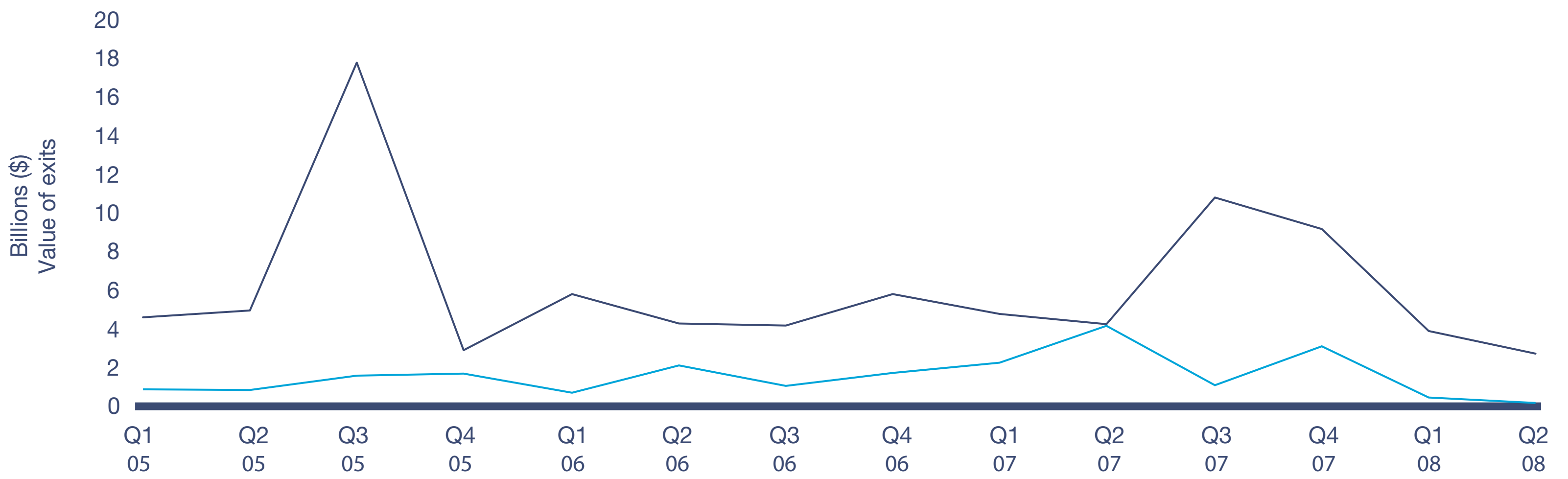
VC-backed M&A deals still flowing . . . but slowing

The poor exit climate also led to sagging VC-backed M&A activity, as valuations that may have appeared attractive to acquirers in the heady 2007 M&A market looked less so amidst 2008's troubled economy. The volume of VC-backed M&A deals in the first half of 2008 reached 120, down 29% from 169 in the first half of 2007. In deals with disclosed value, the volume fell to 42 deals with an aggregate value of $6 billion, compared to 65 deals totaling $8.5 billion in the first half of 2007. Of this group, the deal value averaged $143 million, falling from an average deal value of $178 million for all of 2007.

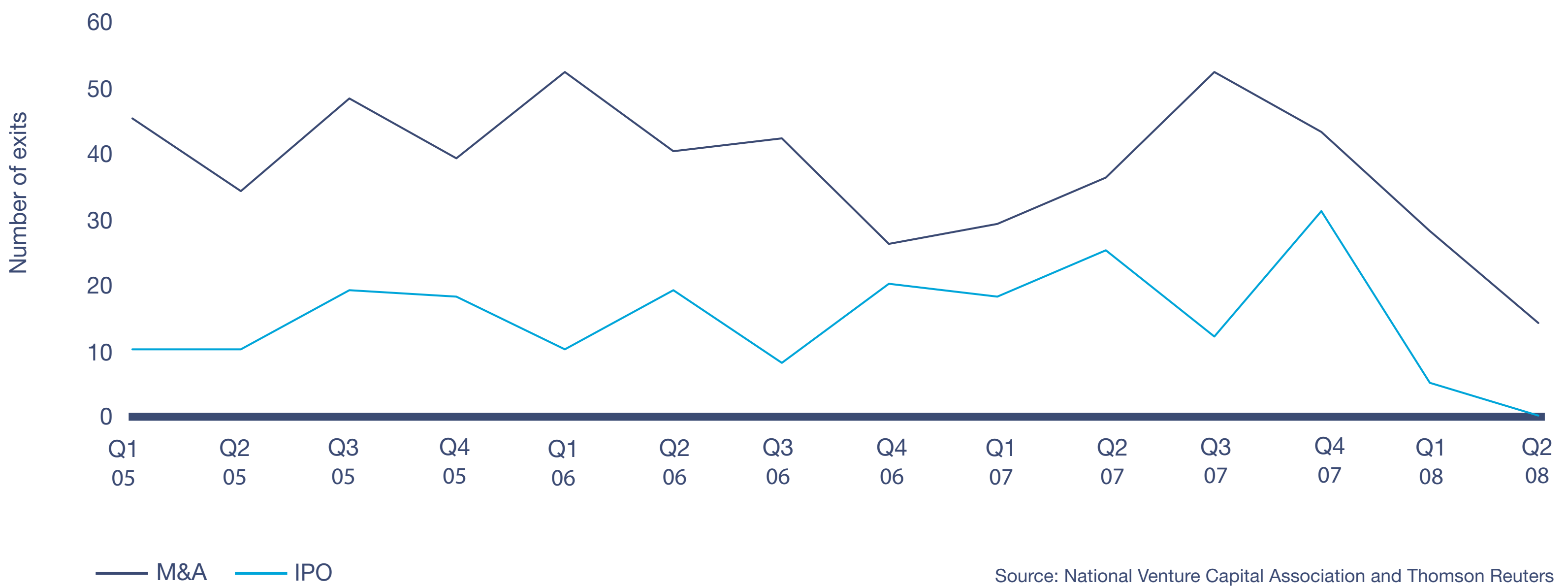
While M&A activity was certainly more robust than the IPO front, it is important to note that two large VC-backed M&A deals combined to account for nearly half of the total disclosed deals. Dell Inc.'s January buyout of storage area network solutions developer EqualLogic for $1.4 billion was the largest disclosed acquisition of the first half of 2008. AOL's purchase of social networking site Bebo for $850 million was the largest VC-backed deal of the second quarter. Information technology deals far outweighed other sectors in the first half of 2008, comprising 77 out of 120 deals, or 64% of the period's total.

As indicated in Figure 1, the exits share of VC-backed IPOs has diminished in both value and deal number relative to the VC-backed M&A exit share.

Figure 1. VC-backed exit counts: IPOs and M&A deals with disclosed values



Source: National Venture Capital Association and Thomson Reuters



Source: National Venture Capital Association and Thomson Reuters

Sinking confidence

The exit drought has done little to lift confidence levels among venture capitalists, at least in Silicon Valley. According to the Silicon Valley Venture Capitalist Confidence Index (which reflects confidence levels of venture capitalists in the San Francisco Bay area, including Silicon Valley), venture capitalists' confidence levels have slipped precipitously since the beginning of 2008, a period coinciding with the exit drought.

Figure 2. The Silicon Valley venture capitalist confidence index (Q2, 2008)

Source: Mark V. Cannice, PhD, University of San Francisco. Note: The index surveyed, in Q2 2008, 54 San Francisco Bay Area / Silicon Valley venture capitalists on their estimation of the "high growth venture entrepreneurial environment in the San Francisco Bay area over the next 18 months."

Stuck in the S-1 line

The exit slump has produced a backlog of VC-funded businesses that may have been positioned for acquisition or public offering had more favorable conditions prevailed. Indeed, there's such a long queue of VC-backed companies that have filed form S-1 (the SEC registration statement filed in the initial public offering of securities) that some are beginning to leave the line—either by postponing offerings or pulling out of registration altogether. VCs had 42 companies in registration for an offering at the end of the first half of 2008, as indicated in Figure 3. The long wait deviates sharply from the trend since 2003, when the number of VC-backed IPOs far exceeded the number of companies in registration.

Figure 3. Registrations outpaced IPOs in the first half of 2008

Source: National Venture Capital Association and Thomson Reuters

The exit drought comes in the wake of a particularly strong year for the market's receptivity to VC-backed IPOs. By the end of 2007, the year had seen 86 completed VC-backed IPOs, compared to 60 companies in registration. Few VCs are expecting liquidity from the public markets to improve anytime soon. "Venture capital sits at an early point in the capital markets' food chain," said Eric Young, general partner and cofounder of Canaan Partners. "In the current bear market environment, the ability of private companies to raise capital in the public market via an IPO is relatively unavailable. This puts a lot more of the burden on the private capital markets to fund the needs of later stage, emerging growth markets."

Amidst current conditions, it is likely the trend line in S-1 filings from mid-2007 to mid-2008, marking 22 fewer companies, will continue downward. An uptick could augur bullish sentiment among financial-sponsored IPOs, but there is no indication that the market is about to truly recover. Considering a lead time of a couple of quarters between filing and going public, a genuine IPO market recovery is unlikely sooner than the first half of 2009.

According to venture capitalists, the S-1 backlog won't translate into a release of IPOs anytime soon. Seventy-five percent of venture capitalists predict the IPO window opening again in the next one to two years, according to a poll of 662 venture capitalists carried out by the National Venture Capital Association. Most respondents ranked skittish investors, the credit crunch, and Sarbanes-Oxley requirements as the three most important factors behind the IPO slowdown.

Wooing strategic investors

The backlog in S-1 filings is not unlike a reportedly lengthening queue of potential M&A acquirees. “There is a backlog of venture-funded businesses being built up, and only a limited number of them will actually be bought or go public any given year,” said Brian O’Malley, senior associate of Battery Ventures LP. “Acquirers will often look towards strategic fit above just financial performance. While an acquisition is the exit for the venture investors, it is only the first inning for the acquiring companies, so they need to be cognizant of how many teams and what types and sizes of companies they can successfully integrate with their business in a given timeframe.”

As challenging as the exit slump is for venture capitalists, it places strategic investors squarely in the driver’s seat. Looking to the rest of 2008 and 2009, VCs expect strategic investors to remain buyers for core strategic fits at attractive valuations. “We are seeing the big corporate buyers, such as Cisco, Microsoft, SAP, Oracle, Yahoo, and Hewlett-Packard—that have traditionally bought VC-backed companies—still actively looking to buy,” said Gregory Gretsch, managing partner of Sigma Partners.

Naturally, VCs aren’t rushing to advertise discounts just yet, leaving strategic investors—especially those with cash to spend—in a comfortable wait-and-see position. Potential targets are quickly losing the leverage a hungry public market could provide to justify premiums for buyouts. The tight exit market could be motivating VC-backed enterprises that don’t see an exit on the near horizon to look into establishing partnerships with potential suitors.

“It’s been like a staring contest, but increasingly, with the IPO window shut and the acquisition [window] now wide open, there are more choices for acquirers and valuations are becoming more attractive,” said Claudia Fan Munce, managing director of IBM Venture Capital Group. “We’re getting more and more VC-backed companies coming back to us after declining previously, to revisit talks on partnerships and acquisitions, and we expect that to continue.”

VC investment forging ahead despite exit slowdown

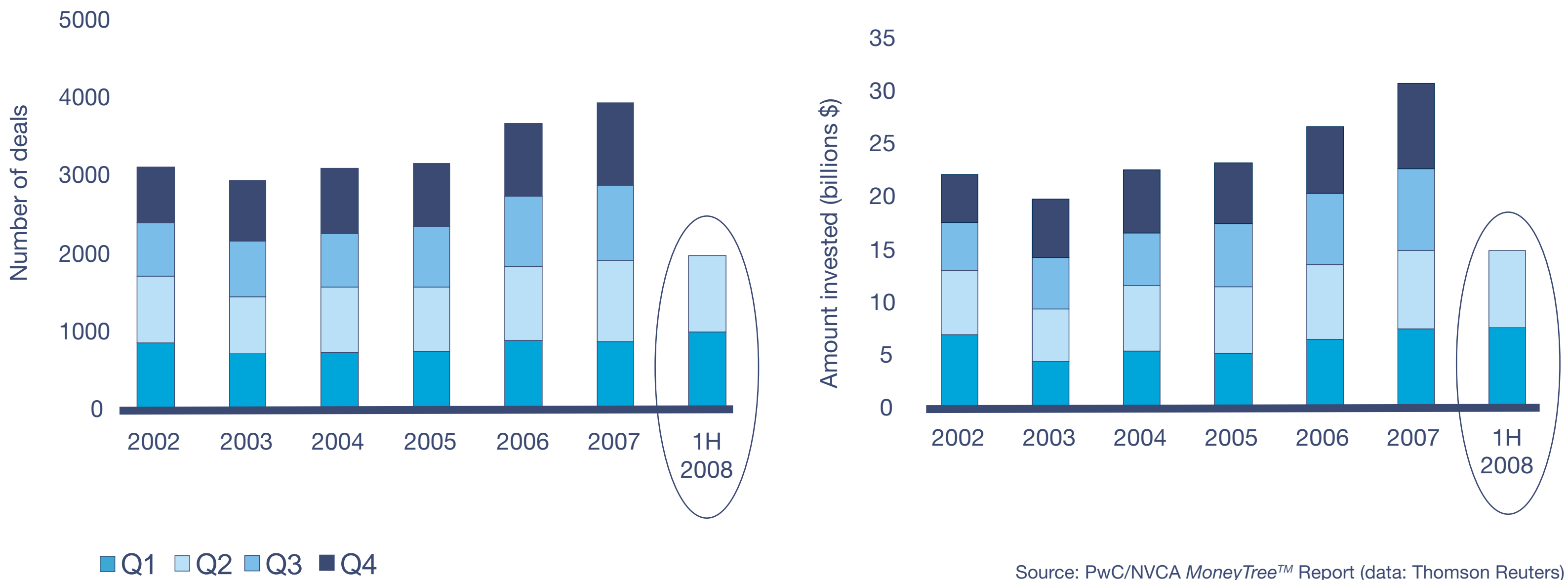
Funding and fund-raising still solid

Despite the exit crisis, VCs are still investing and still raising funds. Over the first half of 2008, VCs invested at a fairly solid clip—about $62 million higher than the same period in 2007. This differs from the Internet bubble, "when VCs stopped investing, customers stopped buying, it was a nuclear winter," said Sigma Partners' Gretsch. "Now, M&A and IPOs have slowed, but customers are still buying, and we have yet to see the macro trends of our companies affected by the economy."

Fund-raising activity, too, has held its ground, with 70 VC funds raising $7.1 billion in Q1 2008 and 71 funds raising $9.1 billion in Q2 2008. Of the 141 VC funds raising capital for the first half of the year, 110 were follow-on funds and 31 were new funds.

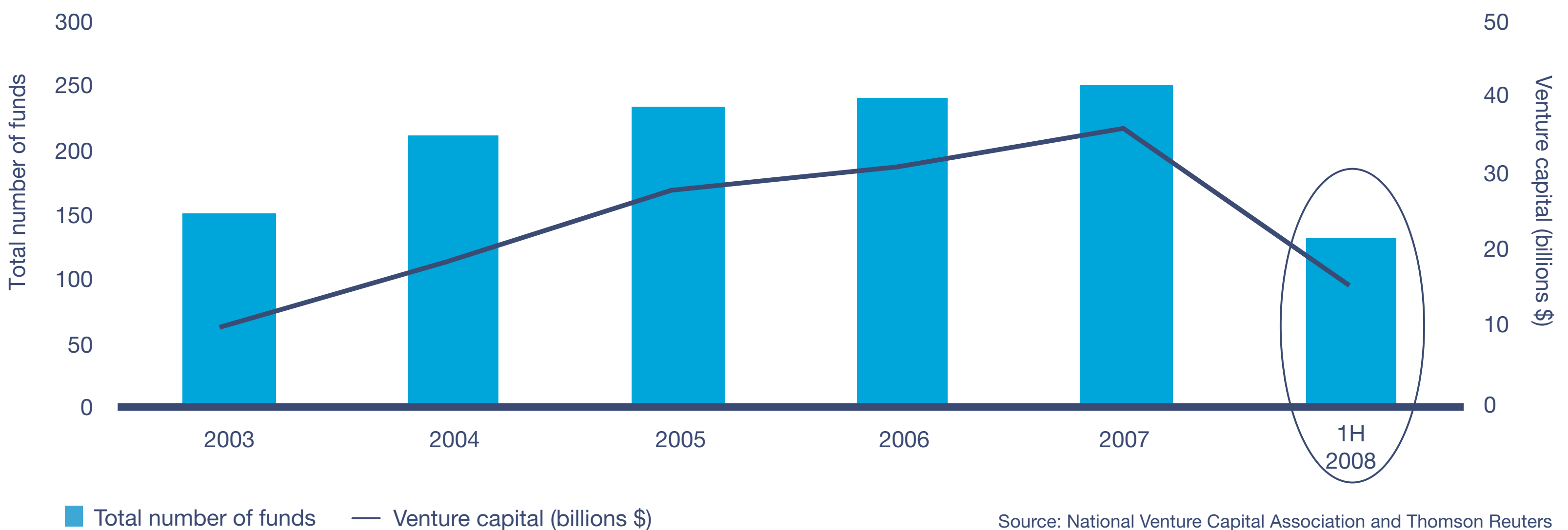
"Even though the IPO activity has slowed dramatically over the past year and M&A activity has slowed down as well, most of our portfolio companies are continuing to deliver the fundamental performance that they have been building toward," said Canaan Partners' Eric Young. "We are particularly enthused at the prospects for our digital media and Web 2.0 companies, as traditional broadcast media is being cannibalized by web-based media. Also, in the power and energy sector of cleantech, we have only seen the tip of the iceberg. The trend line to the future in that area is enormous."

Figure 4. Despite the exit crisis, VCs continue to invest (2002–1H 2008) . . .



Source: PwC/NVCA *MoneyTree*™ Report (data: Thomson Reuters)

Figure 5. . . . as fund-raising activity holds steady (2003–1H 2008)



Source: National Venture Capital Association and Thomson Reuters

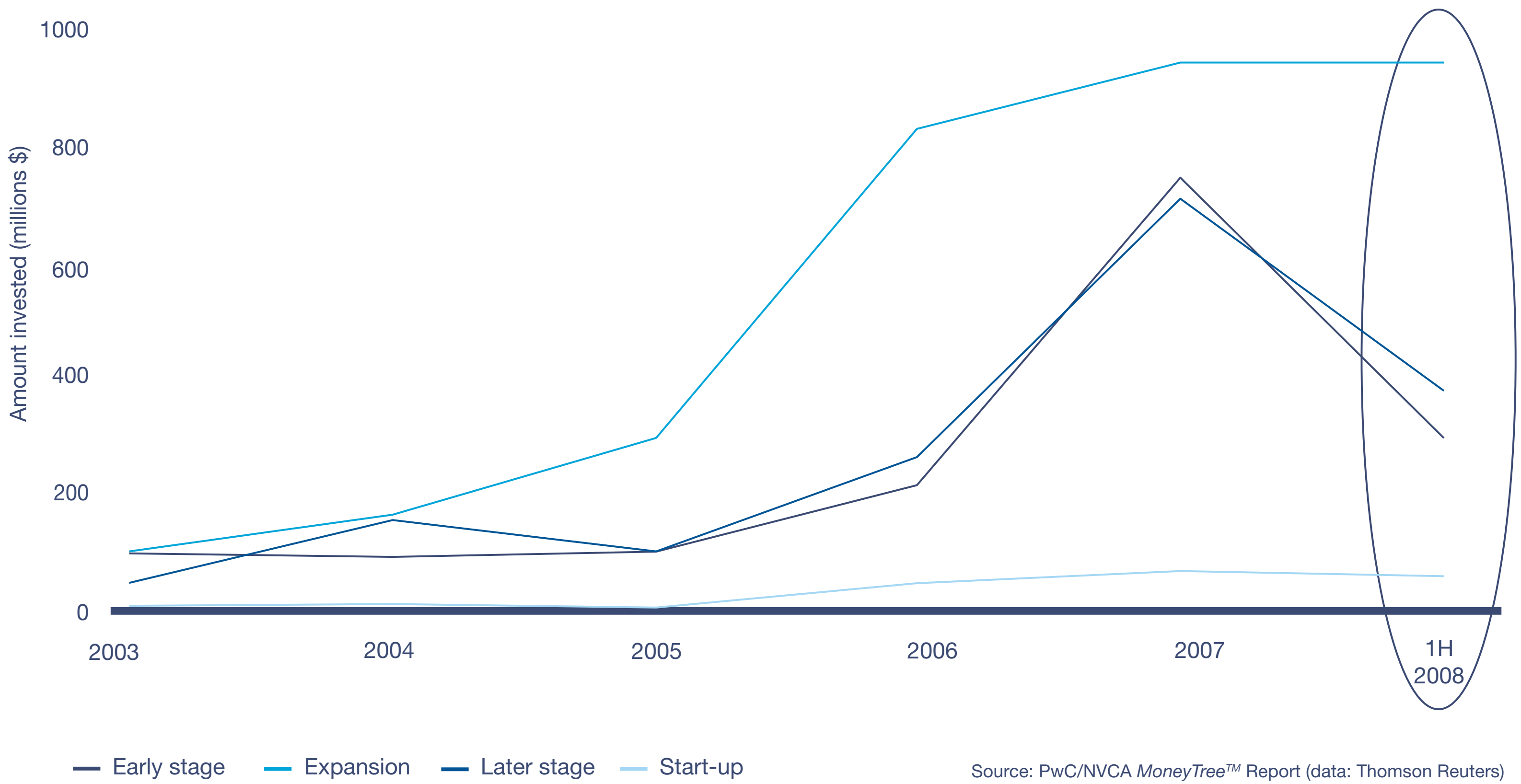
Cleantech investment powers on

Cleantech funding, which surged in the last couple of years, continues to be strong. In May 2008, Kleiner Perkins Caufield & Byers created a $500 million “green growth fund,” followed one month later by RockPort Capital Partners with its $450 million fund focusing solely on cleantech. “We’re at an interesting point in time,” said RockPort general partner Chuck McDermott. “Institutional investors don’t make decisions on quarterly outlooks. They’re looking at the longer-term macroeconomic, regulatory, market, and consumer trends, and they’re voting with their checkbooks in support of the potential in the cleantech sector.” Indeed, the only two VC-backed IPOs in the first two months of Q3 2008 were cleantech companies Energy Recovery and GT Solar.

The infusion bodes well for VC-backed, capital-intensive companies that are still maturing or waiting for an exit. VCs have been filling the pipeline for cleantech companies, investing heavily in expansion and later-stage companies. Investments in expansion-stage companies rose five-fold from 2003 to 2007. Likewise, the average deal size nearly tripled in expansion and later-stage cleantech companies over that period.

Similarly, investment in the life science sectors has shown staying power and is likely to continue through the economic downturn and exit drought as patents on pharmaceutical and medical device products expire.

Figure 6. US VC-backed cleantech investment by stage of development (2003–1H 2008)



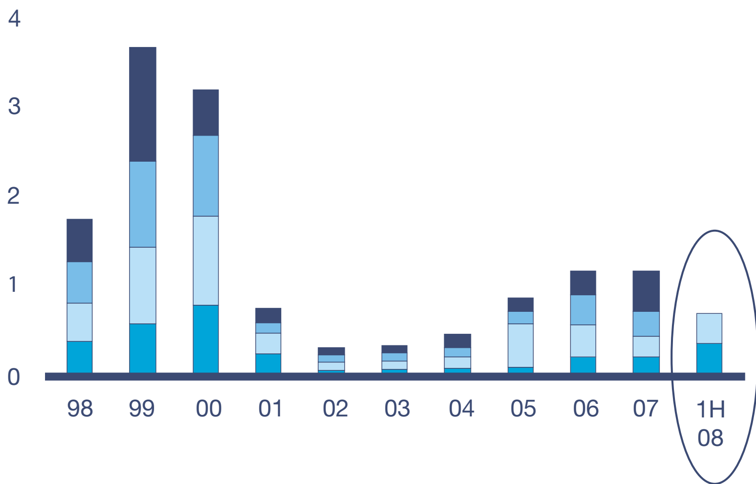
Source: PwC/NVCA *MoneyTree™* Report (data: Thomson Reuters)

Feeding both ends of the pipeline

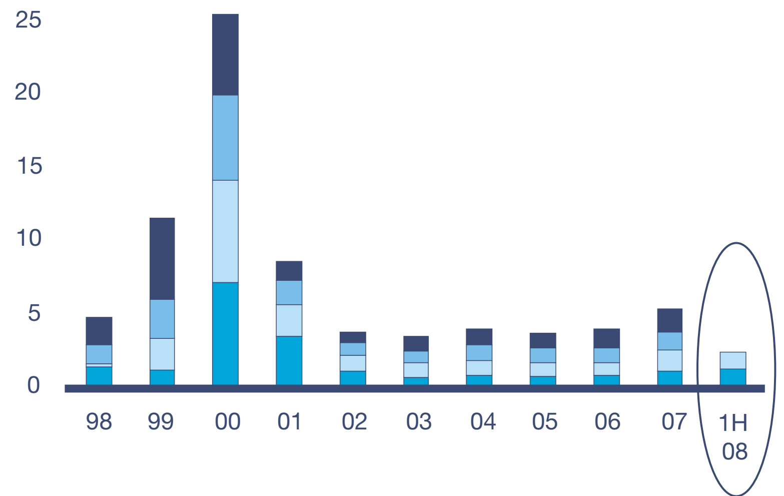
VC investment in start-ups remained robust through the exit drought, while funding of capital-intensive sectors such as cleantech and life sciences continued. This suggests a trend of more accelerated investment at both ends of the pipeline—in start-up/seed companies and in more mature (especially later stage) companies, as shown in Figure 7. Despite a shortage of liquidity, it seems VCs are still positioned to fund the most mature companies, perhaps longer than once anticipated. Additionally, this continued funding appears not to be impacting VCs' ability to feed seed companies and keep the pipeline full.

Figure 7. Amount invested in development deals (by quarter in $ billions)

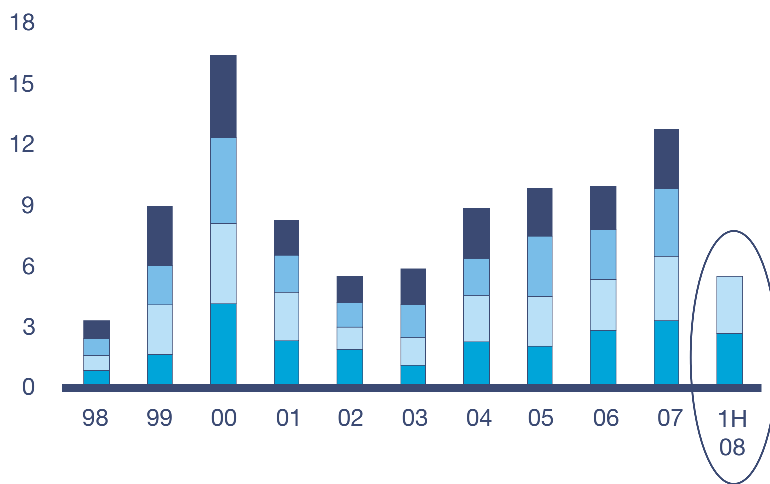
Start-up



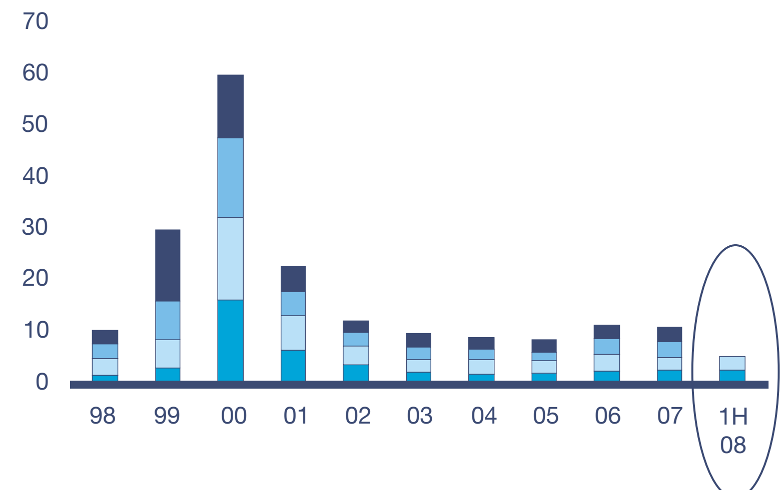
Early stage



Later stage



Expansion



Source: PwC/NVCA *MoneyTree™* Report (data: Thomson Reuters)

Do tough times build strong companies?

Some VCs reason that austere economic conditions have historically been times of building strong companies. Waiting for the M&A/IPO pendulum to swing back to better times, VCs project companies that are now exit-ready will be even stronger and more stable given another year or two to mature. “The next crop of VC-backed companies will be all the stronger because they’ll grow during the lull,” said Sigma Partners’ Gregory Gretsch. “We have three companies that would, under normal conditions, be ready to go public this year, and when the IPO window opens again, they’ll be that much stronger.”

“In the next crop of companies, you’ll see unusually few that will hit a bump, such as disappointing in meeting earnings or sales expectations,” Gretsch continued. “There were so many IPOs in 2000 that VCs were scraping the barrel with companies which were not well-prepared to go public.”

As investor appetite for cleantech companies continues to heighten despite the economic downturn, VC-backed cleantech companies, in particular, may well face brightened IPO prospects, and may help lead the next pack of public offerings.

Looking forward

Bigger IPOs, but fewer of them

As VCs enter what seems to be a trying period, certain trends will likely become entrenched and could alter the industry landscape. Given companies' longer life cycles—8.6 years from seed financing to exit, according to the National Venture Capital Association, roughly double what it was a decade ago—VCs will likely continue to invest more per company overall and rely on larger exits to maintain expected returns. Additionally, the average VC-backed IPO is likely to become bigger than the historical norm, given the higher costs associated with Sarbanes-Oxley requirements and the rising expectation that a threshold of about $500 million in market capitalization offers a good chance to attract equity analyst coverage.

"We can't sit here and worry about when the window will open again," said Mike Carusi, general partner at Advanced Technology Ventures. "Five years ago, we thought a $150 million take-out was the top. Now, we have companies that will potentially exit at $500 million or $1 billion plus, but that may mean waiting another year or two for that to happen. We will see some $1 billion plus exits. When that happens, you will see mezzanine players, larger VCs, and strategic investors rush back in." These large expected future exits would sustain the increased spending required by VC-backed companies' longer life cycles and satisfy the returns expectations of the VCs and their LPs.

M&A continues as dominant exit path

Acquisitions have grabbed an increasingly large chunk of the exit pie since the beginning of the boom-and-bust Internet years. With the VC-backed IPO market at a 30-year low, the M&A chunk may well continue to get bigger.

“One trend is seeing lots of smaller acquisitions under $100 million and even more under $30 million,” said Battery Ventures’ Brian O’Malley. “With these numbers, the old 20x plus return investments are rare. So instead of hoping for one home run to return the fund, firms need to make a higher percent of their investments accretive. Several firms are pushing to get involved earlier while others are less syndicate-friendly in hopes of retaining higher ownership percentages.”

It is probable, then, that the public markets will become less receptive to smaller, less mature companies—at least at the rate seen in previous years—and that acquisitions could continue to account for an ever-larger slice of the exit pie.

With VCs remaining committed to their portfolios and experiencing little trouble raising funds for continued investment, a central question is whether companies funded by those investments will continue to perform and, when the exit climate does recover, whether they will, in fact, be stronger.

The credit crisis, and the inflationary pressures on energy and food, may well spill over into the wider economy, dialing up pressure on VCs to keep their stable of mature companies in good, exit-ready shape. The effect of the economic downturn on these companies is the one real wild card, said Jeff Crowe, a general partner at Norwest, adding that some companies will be more inured to these pressures than others: “Tech companies may be able to endure even through inflationary times, because most of their costs are people costs. The commodity-based industries would be harder hit.”

The exit slump opens the acquisition window for strategic investors, just as it weakens the bargaining leverage available to VCs during robust IPO environments.

What this means for your business

The implications of an exit slowdown

In the face of poor economic conditions, venture capitalists are facing a sharp decline in exits and the liquidity that results, yet they're continuing to raise funds and invest in their portfolios at a relatively strong pace. Quite simply, VCs are braving an IPO drought and a thin M&A market, but are also building through the inhospitable exit climate.

The exit slump will likely further extend the seed-financing-to-exit life cycle of the average VC-backed company, which at 8.6 years is currently about twice as long as it was ten tears ago. As a result, VCs are facing extended financing for later-stage companies that might have otherwise been ripe exit candidates. VCs are also under pressure to grow IPO candidates big enough to succeed in a more rigorous and expensive IPO process—and once they do go public, these companies need to be mature and relevant enough to attract analyst coverage and avoid the twin shoals of thin trading and price volatility. These trends portend larger but fewer VC-backed IPOs going forward.

These bigger exits may ultimately translate into less lucrative investments, as VCs pour larger-than-expected private funding into companies at high valuations during an exit slump—effectively raising VCs' average costs. If exits, in general, do tend to become less lucrative going forward, VCs may become less likely to invest in capital-intensive and longer-to-maturity start-ups.

The exit slump, however, opens the acquisition window for strategic investors, just as it weakens the bargaining leverage available to VCs during robust IPO environments. Strategic investors may benefit from falling valuations, but that remains to be seen. Until the IPO market comes back to life—a resurrection not expected by VCs for at least another year—M&A activity is also expected to lag, both in number of deals and in the valuations of those deals.

Despite this, it is probable that M&A deals will continue to be the most viable exit channel for VC-backed companies, as venture capitalists and their portfolio companies ride out the IPO exit slump. This trend could help recast the role of venture capitalists from pipelines producing a steady flow of IPOs to incubators for the strategic investment community.

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