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Third exit option will ease pain from sluggish IPO, M&A markets

by: Stuart Davidson, Labrador Ventures – December, 2006

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Anemic IPO Results?

Here's an ominous statistic: Only eight venture-backed companies went public in the third quarter of 2006, raising just $934.2 million. This compares dimly with the previous quarter, when 19 venture-backed companies went public raising more than $2 billion. And in the same period last year, another 19 venture-backed companies went public, raising $1.5 billion, making the most recent IPO results look even more anemic.

That's not all. *The National Venture Capital Association* and *Thomson Financial* report that acquisitions of VC-backed companies saw a marked drop in volume and value this past quarter. Just 74 companies were acquired for a total disclosed value of $2.7 billion. Average deal size? About $80 million, compared with $100 million in the prior quarter.

One last data point: There were 91 total acquisitions in the second quarter of this year, 25% more than the 74 buyouts in the most recent quarter, which were down even more significantly from the 98 M&A transactions a year ago. "We would like to see the number of transactions increase 15% to 20% next quarter as investors cannot enjoy the quality rates of return if the two major paths to liquidity are not open to them," notes *NVCA* President Marc Heesen.

With news like this, it's no wonder that *Sevin Rosen Funds*, one of the largest and most respected names in venture capital, opted to release investors from commitments made to its most recent fund (*Sevin Rosen X*), stunning the venture community and leaving others to wonder if the venture capital model was, indeed, truly broken.

The good news for earlier stage VCs is that such trends are still largely over our heads. Better yet, there are emerging trends on the liquidity side that are actually playing to our favor, namely, the introduction of greater numbers of private equity firms and hedge funds looking to do an ever increasing number of deals within the venture market. If IPOs were once our golden exits and M&As were our singles and doubles, private equity money and the rollups they're pursuing are now a welcome third strategic exit opportunity that we hadn't seen much of before. It's a new opportunity that we expect to insulate early stage investors from the problems plaguing Sevin Rosen and others.

The specific trend that's changing the venture landscape is one of a massive infusion of private equity investing into emerging businesses and rollup opportunities, allowing firms such as *Francisco Partners* and *Golden Gate Capital* to look beyond traditional M&A and into how venture-backed startups can roll up into their own strategic acquisitions.

"The big trend is towards private equity as a platform for several underlying businesses, where you have a strategic buyer and a financial backer," says David Parker, head of technology M&A with investment bank *Piper Jaffray*. "The private equity guys are awash in money on the sidelines and are looking to put it to use." To wit, 103 private equity funds have raised $83.9 billion this year, more than three times the amount raised by VCs, according to *Thomson Financial*.

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This excess capital creates an interesting dynamic within the financial calculus of any deal, and one worth understanding on the part of early stage investors as they evaluate whether exit opportunities are indeed slipping away. In the past, where you might have had just two different buyers for a specific company – a financial acquirer that's looking at cost and valuation, and a strategic that's looking at customers and channels (think *KKR* vs. *Cisco*) – you might now have a third, a strategic buyer with a private equity backer that can outbid both of them. "It takes the valuation calculus and adds another dimension," says Parker.

As recently as September, an investor group that included *Silver Lake Partners*, *KKR*, *Bain Capital*, *Apax Partners*, *AlpInvest* and others acquired 80.1% of the semiconductor operations of *Royal Philips Electronics* for 8.3 billion euros ($10.6 billion). The spinout, having since been renamed *NXP*, is now one of the world's largest semiconductor companies, creating semiconductors, system solutions and software that deliver better "sensory experiences" in mobile phones, TVs and other electronic devices.

Why is this deal significant for VC investors? One, it represents a major deal for the private equity guys where they were able to place a large chunk of capital to work on a spinout that now becomes its own platform for innovation and acquisitions; thus, the semiconductor industry now has another deep-pocketed player in its midst. Two, whether most people realize it or not, this isn't the *RJR-Nabisco* deal of old where a private equity firm paid a fortune for the deal, but fueled it primarily with debt. Here, 3.8 billion euros worth of the purchase price represented equity, meaning that the new company is no longer squeezed to cut costs and trim assets for the acquisition make financial sense. In other words, the additional infusion of equity over debt allows the strategic side of the business to work with an eye toward execution and growth. This will allow *NXP* to become an acquisition platform for VC-backed companies.

On a smaller scale, *Francisco Partners* and *Vector Capital* in October announced they had collectively acquired *WatchGuard Technologies*, taking the network security company private in a $151 million deal. *WatchGuard* can now become a rollup vehicle in the network security space, freed from the constraints of public company reporting requirements and earnings reports. And with deep-pockets behind it, *WatchGuard* can be a much more dominant and flexible player in the network security market, achieving growth organically and through acquisition.

And though the Q3 M&A numbers for venture-backed companies were down significantly, the broader acquisition numbers for 2006 are actually forecast to increase nicely. The tech sector not only remains the most popular M&A sector across all industries, but the total number of M&A transactions should reach 282 this year, up from 243 in 2005, according to *VentureSource* and investment bank *Seven Hills*. Within the tech sector itself, communications, semiconductors and software are each expected to show increased deal transactions as further excess capital is deployed by strategic acquirers and private equity firms alike.

Was *Sevin Rosen* right to release the commitments to Fund X? Perhaps. But its model is very different than that of an early stage firm such as Labrador and others. The valuation entry points for *Sevin Rosen* and other large venture funds are too high to expect any reasonable returns from venture investing. But when you're an early stage investor and your entry point is often $5 million pre-money or less – and the average M&A deal is about $74 million – you can still enjoy a very attractive exit. When you toss in the increased funds available for acquisitions via the private equity firms and their own strategic acquisition platforms, exit opportunities have never looked better for smaller venture funds.

This is one in a series of monthly columns on seed and early stage investing that Labrador Ventures was selected to contribute to the *Venture Capital Journal.*

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