

Tough Times Ahead For Start-Ups Raising Second Rounds

by Scott Denne and Tomio Geron

Sanjeev Agrawal found venture capitalists to be a risk-averse bunch over the past two months as he began looking for new investors to back Aloqa Inc., the mobile application start-up where he's chief executive.

"That's not very encouraging to entrepreneurs who are doing something, because they are risk takers," he said. "Obviously, we're not talking 2007 here, but sometimes the number of proof points you need to provide to show you'll be a big company can be overwhelming."

Though Agrawal is confident that Aloqa, whose software helps people find restaurants, friends, real estate and other products and events based on their locations, will close its Series B round in the next two months, many start-ups may be in for an unpleasant surprise in 2010, some investors say.

Last year was one of the toughest years to raise capital in the decade, with venture investment falling 31% to \$21.41 billion. The decline has left a large backlog of start-ups in need of financing to keep operations going, and many venture investors say they're still cautious coming off the economic certainty of 2009.

To make matters worse, many venture firms are having fundraising problems of their own -- just \$13 billion was raised by these investors in 2009, less than half the \$28.7 billion recorded in 2008, according to Dow Jones LP Source. Despite economic indicators that signal a possible recovery, the venture industry is expected to contract significantly as limited partners threaten to pass on poor-performing firms.

Meanwhile, venture firms are trying to keep alive portfolio companies they thought would have exited by now. All of this means the pace of start-ups shutting down or selling their assets may accelerate.

"We're going to be living through a Darwinian process where only the most successful survive," said Bob Ackerman, managing director at Allegis Capital. "All those that had made it so their round would last at least two years - those companies will be in the market in 2010 looking for money. There's going to be a lot more demand than supply. Something's got to give."

On the positive side, the recession caused many start-ups to cut back and become more capital-efficient, a trend that should continue, said Saul Klein at Index Ventures.

"I think there'll be continued rationalization in 2010 although most that have made it through the last 12 months probably made it through because they were extremely capital-efficient

or because they're starting to find their sweet spot with customers, adoption, usage and business model," Klein said.

Disappearance of the Series B

Most venture capitalists spent the first half of 2009 focusing on their existing portfolio companies to determine which companies they should continue to support, leaving little time to invest in new deals. The number of inside rounds for all financings jumped to 60% in the first three quarters of 2009 after averaging just under 40% for the past 11 years, according to VentureSource, a research unit of Dow Jones & Co.

"What I saw this last year were investors asking, 'What do we have to do to get [this company] to the next year?' rather than giving them all the capital they need to reach the next stage of growth, said Wayne Cantwell, a general partner with Crescendo Ventures.

Two types of start-ups had and will continue to have different challenges, said Nat Goldhaber, managing director at Claremont Creek Ventures: those that are still developing a product and those with a product making a big sales push. Even companies that are hitting their targets could have a tough time when looking for funding.

"For those still in the development phase, not much [bad] has happened except it's very, very difficult to raise a Series B round," Goldhaber said. "The conventional B round all but disappeared in 2009."

Of the technology companies that raised a Series A round in 2008, only about one-quarter of them returned to market to successfully raise a Series B round, according to VentureSource. That compares with over 40% of companies that raised a Series A round in 2006 and followed that with a B round the next year, suggesting that there is a larger-than-usual inventory of companies that will be needing fresh capital in 2010.

"It's worse for those companies geared up for sales," Goldhaber said. "They have a reasonable anticipation of sales but the sales never manifested. So organizations needed to be drastically trimmed. Normally they'd have the B round but now it's not there. So they got double-slammed."

Most venture capitalists feel comfortable investing in the process of invention and product development, but when a company has little or no sales, the economic uncertainty makes it especially tough to price a new round. Some investors recommended that companies build a syndicate in the Series A that is willing and capable of financing it through the B round. Jo Tango, a partner with Kepha Partners, adds that start-ups

need to make sure they're making real, clear, tangible progress in their business. Whether talking to new investors or existing ones, "everyone wants to see progress," he said.

The Upside of it All

Even with all the turmoil, some venture firms have remained very active in investing, and others are starting to come back for new investments. Firms including Greylock Partners, Khosla Ventures, New Enterprise Associates and Norwest Venture Partners all raised giant-sized funds in 2009 and have plenty of capital to deploy.

Klein said Index, which closed a \$440 million fund in 2009 and invests across several sectors and geographies, has been seeking to invest in "unfashionable" sectors as a way to find good deals. Just as it did from 2002 to 2004 after the dot-com crash with out-of-favor consumer Internet plays, Index has during the downturn been looking at ecommerce, mobile, location-based services, alternative payments and gaming companies.

Amid all the doom and gloom there have been definite signs of some heat, such as bidding wars for new investments in start-ups perceived as leaders or first movers in their respective areas. "We've seen a fair number of preemptive offers, people going after what they perceive as winners," said one venture investor at a large venture firm who did not want to be named.

Two recent examples are Playdom Inc., a hot social gaming start-up, which had multiple bidders before it landed a \$43 million Series A led by New Enterprise Associates, and HubSpot Inc., which got a pre-emptive bid for its \$16 million Series C before it started looking for funding.

And some VCs, like Venky Ganesan of Globespan Capital Partners, remain optimistic that the exit markets will rebound in 2010 and give limited partners confidence to reinvest, digging the venture industry out of its hole.

"I feel pretty confident it'll be a good year for venture in terms of exits and liquidity," the managing director said. "The time to enter an asset class is when everyone is shouting from the rooftops that it's dead. You didn't want to enter in 2000 and you don't want to leave in 2010. LPs who understand the asset class and that it's cyclical in nature are definitely staying with it and in some cases doubling down."

Todd Chaffee, general partner at late-stage firm Institutional Venture Partners, also said he expected mergers and acquisitions and IPOs to be strong in 2010, barring any major unforeseen shock to the financial system. While those that are not top companies will have trouble getting funding, those in strong positions will see quick financings and up rounds.

"We're working on a theory that it's going to be an amazing year for venture-backed IPOs and M&A activity," Chaffee said. Chaffee said IVP has several companies that are potential IPO candidates if the market is right.

However, with many venture funds already stretching their reserves, it's likely to be a tough year for companies that are leaning hard on their existing investors.

"Insider support can only last so long," said Rick Grinnell, a managing director with Fairhaven Capital. "If there isn't the ability to attract outside interest at some point in the storyline, the insiders will eventually lose interest."