

NOW WHAT?

Strategies for how to get through the economic crisis and revive the market for venture-backed IPOs

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PART 1: Confronting the economic crisis

For entrepreneurs, running a technology startup is literally that: a race to get revenue to outpace ever-mounting costs. The message from VCs up and down Sand Hill Road last month to their portfolio executives was simple: “Run faster.”

It’s by no means a new message. But VCs dialed up the intensity last month as Wall Street panic spread to Sand Hill Road.

The great venture capitalist freak-out of 2008 began when blue chip firm Sequoia Capital told the CEOs of its portfolio companies to assemble for a mandatory meeting and ordered them to get to cash flow positive as soon as possible. “Forget about getting ahead, we’re talking survive,” General Partner Michael Moritz advised the group. “There will be consequences for those who hesitate. Act now.”

The CEOs took it seriously. In the 10 days following the meeting, three Sequoia-backed companies laid off employees and one shut down entirely, while at least half a dozen other venture-backed companies trimmed their staffs.

Desperation radiated in waves from the meeting. One executive who attended took detailed notes and sent them to his team and other investors. The email went viral and in no time half the VCs in Silicon Valley had read it. Two days later, the PowerPoint Sequoia used at the meeting found its way onto the Internet. The opening slide—with the words “R.I.P. Good Times” written on a tombstone—was seared into the psyche of VCs and entrepreneurs alike. (See slideshow here: [Sequoia Presentation for CEOs.](#))

Was the death spiral really what awaited venture backed companies? It certainly seemed that way as the Dow Jones Industrial Average lost more than 20% during the week. “Maybe I should invest in canned foods and a gun,” one VC said only half jokingly at the time.

Other big name investors weighed in, begging their startups to conserve cash, get profitable and take an acquisition offer if it came.

Angel investor Ron Conway repeated advice he’d given in the spring of 2000: “The message is simple: Raising capital will be much more difficult now.”

Bill Gurley of Benchmark Capital echoed that sentiment in an email he sent to portfolio company CEOs several days before the Sequoia meeting. It reads in part:

“Access to other forms of capital that have recently been available to venture-backed companies may be dramatically impacted. One would naturally assume that the hedge fund rounds of late 2007 and early 2008 are no longer available. Additionally, we would expect that strategic/corporate investments, venture debt facilities and even angel financings would all contract considerably. In all previous economic downturns, this was certainly the case. If we leave you with one message it would be this: financings as we know it just got a whole lot tougher. Basically, the cost of capital is going way up.” (See the full letter here: [Benchmark Letter To Portfolio Companies.](#))

What Changed?

First the credit crisis was just about housing, but VCs didn’t care because they weren’t investing in real estate. Then the crisis called other debt into question, but VCs continued business as usual because they didn’t take out loans. Then the crisis came for the Wall Street banks and that seemed pretty bad, but VCs said the IPO market was closed anyway and it wasn’t going to affect them. Then the crisis came for them.

At least that’s the way it seemed when Sequoia called its all hands meeting. Eric Upin, a public market investor for the firm, told the assembled CEOs that the credit crisis was going to be a long-term problem. “It’s always darkest before it’s pitch black,” a source reported him as saying. “We are in the beginning of a long cycle. This could be a 15-year problem.”

But a week before Sequoia’s meeting, VCJ conducted a survey of close to 50 VCs and nearly 75% of them said they expected the stock market to recover in 12 to 18 months (see October VCJ.) Of course, that was before the Dow dropped below 9,000.

It wasn’t the drop that spooked investors as much as the volatility. Jim Armstrong of Clearstone Venture Partners remembers sitting in a trendy business lunch spot in Santa Monica, Calif., with his partners last month. The group had a nice lunch, but couldn’t stop watching the CNBC Dow fever chart on a flat screen television mounted behind the bar. They were lucky to catch it on a good day, at the end of a weeklong slide. “It was up more than 200 points during the hour we were sitting there,” he says. “How do you plan with that level of volatility?”

Uncertainty has been the keynote of every economic, business and political discussion since the beginning of September. It’s not just “What’s the market going to do?” or “Will my bank exist next quarter?” It’s also “Will Congress pass the bailout bill?” and “Who will be president?”

Alexandra Johnson, who makes venture investments in Russia, woke up to the troubles the U.S. economy was going through when century-old law firm Heller Ehrman went bankrupt in mid-September. “That was where my American career started,” says the managing director of DFJ-VTB Aurora. “I was a client of Merrill Lynch and my mother was a client of Washington Mutual. We looked at each other and said, ‘People in Russia think they have it tough.’” Since then, she’s had to answer questions from her counterparts in Moscow about whether the U.S. economy is sound.

Maybe it’s that basket of uncertainty that is killing investor confidence. Mark Cannice, a business professor at the University of San Francisco, has been tracking venture capitalist confidence each quarter for the past four years and reported in October that VCs are more pessimistic about near-term growth than at any point since he started his survey. Confidence during the third quarter was down 30% from the same point last year.

Maybe the most interesting result of Cannice’s survey was the variance in opinions on what the financial crisis meant for venture capitalists. Some registered their optimism at the bottom of the scale, others at the top.

The truth is that nobody knows what’s going to happen.

Consider the software sector, a mainstay of the venture business for years. Investors completely disagree about what’s likely to happen in that market alone.

“The question in our minds is, ‘How bad is this is going to be?’” says Trident Capital Managing Director Evangelos Simoudis. The credit crunch has hurt small and medium-sized businesses worse than big companies that have lots of cash, Simoudis says. That’s bad news for anyone selling enterprise software, since SMBs have been their most reliable customers.

Clearstone’s Armstrong sees the opposite side of that argument. Most of the enterprise software companies he’s been involved with through Clearstone are focused on replacing more-expensive alternatives. Whether it’s software-as-a-service or open-source, new software is cheaper than it used to be, he says.

When businesses start looking for low-cost alternatives, they'll be knocking on the doors of his portfolio companies, he predicts.

The actual effect on the software market will likely land somewhere in between. "Up until a couple of weeks ago, most large companies were sticking to their technology spending budgets for 2008," says Will Dunbar of Core Capital Partners, an early stage tech investor. "There's significant risk to technology spending in 2009, but we're just not yet seeing that."

Is Cash Really Gone?

To hear Sequoia, Conway and Benchmark tell it, you'd think it will be impossible to raise any cash from VCs. Maybe it is already.

"It is going to be much worse than when the Internet bubble burst because it touches many more sectors of the economy," says Trident's Simoudis. "And it's much more global than the last bubble was and it touches more integral components of the economy. I know our investment pace will decrease. It would be stupid for me to tell you that we are going to continue doing business as usual." He adds that it's too early for him to say how deep the investment cuts will be.

The inability for some companies to raise follow-on investments is already hurting Stewart Guenther's business. Guenther runs Expansion Partners, a consultancy focused on the needs of rapidly growing, venture-backed startups. Business was booming for his firm as recently as two months ago. He'd hired another team member and moved into new office space. Then things got bad. "Two companies evaporated and one cut its staff in half," he says. A fourth company told him that it would pay his bill as soon as (make that "if") it gets a Series B investment. "Sitting on those accounts receivable and not knowing if I am going to get paid has really put a crimp in my style," he says.

Others are less pessimistic. Early stage investor Alan Patricof, founder of New York-based Greycroft Partners, has been through several downturns since he started venture investing in 1969. He says Sequoia went over the top with its message. "I don't disagree with the comments Sequoia made, but they have to be a little bit tempered with a constructive and positive approach," he says. "Their presentation to CEOs had a shock effect, but they're going to continue investing."

So is Greycroft. The firm is looking to raise between \$125 million and \$150 million for its second fund next year, Patricof says.

In fact, many early to mid-stage investors seem to be optimistic about continuing their investment pace and re-upping with their portfolio companies. "We still have a lot of confidence in the companies we have and are supporting them," says Tom Cole, a general partner at Trinity Ventures, an early stage tech investor. "In fact, we've been trying to ramp up our EIR program over the last few months. We feel like this is the best time to invest not just in startups but in our own organization."

Eric Young, a general partner at Canaan Partners, a large tech and health care investor, isn't convinced that many more startups won't get funded. "Companies that have difficulty raising a financing in this environment are probably companies that would have a tough time raising money in any environment," he says.

Every firm has its own situation and many are taking the downturn as an opportunity to critically evaluate what they've invested in. "We got our entire investment team together and did a top-to-bottom portfolio review and did a review of where each company stood," says Stephen Hyndman, chief financial officer of GGV Capital (formerly Granite Global Ventures), which makes expansion-stage investments in the United States and Asia.

"Our portfolio, by and large is in pretty good shape," Hyndman notes. "We have sufficient capital to support our companies, but saw some where the type of growth they wanted to achieve was accompanied with burn rates we thought needed to be brought down."

Buffet on the Brain

Just because firms plan to continue to support their investments doesn't mean that support will come cheap. Valuations are going to drop. Data from law firm

Fenwick & West show that 72% of all venture capital deals were up rounds during the first quarter of 2008. Based on what's happened in prior downturns, valuations will start to drop significantly. For example, only 27% of deals were up rounds in 2003.

"Companies that got A rounds that are going out for their B rounds but haven't proved out their business models may do down rounds or close," says Craig Cooper, managing director of Saban Ventures, which focuses on early stage digital media deals. "Venture firms are going to be much more aggressive on that front."

That may be bad news for companies looking for cash, but it's great for VCs, who are going to get a better value on anything they invest in. They're sitting on the second most valuable resource in the world behind gold: cash. Many have taken to starting their conversations with some variation of: "It's like Warren Buffet says..."

There's little hard evidence of better deal terms coming along just yet. Still, there are anecdotes of firms that are seeing creative and potentially lucrative deals due solely to the decreasing availability of bank loans. For example, a company recently approached Originate Ventures, which makes early stage investments in Pennsylvania, after a would-be buyer changed the terms of an offer. The company was looking for a way to press back against its potential buyer, but desperately needed money, says Matt Bieber, a senior associate at Originate.

With the banks all but shut down, the company started approaching VC firms. The deal it offered depended on what happened with the acquisition. If the company got bought, it would pay its VCs a multiple on their money, as though it were a short term loan. If the company didn't get bought, it would convert the investment into preferred equity.

"It is an opportunistic deal that purely comes from the situation with the markets," says Bieber. "I expect we'll see more of that."

The First Cut Is the Deepest

Big name companies are already starting to pare down. In September, eBay cut 1,000 workers, Hewlett-Packard said it would lay off 24,600 over the next three years, and graphics chip company Nvidia said it would cut 360.

Private companies are following suit: Electric car maker Tesla Motors announced that it would lay off an undisclosed number of workers, adult content site Zivity cut 33% of its team, Internet radio company Pandora laid off 14%, social network hi5 laid off more than 10%, ad network Glam Media laid off 7%, and webcam content company Seismic laid off seven workers.

More telling may be the number of Sequoia portfolio companies that have announced layoffs since the all hands meeting:

- SearchMe, an online search engine founded in 2005, laid off 20% of its staff. It has raised \$31 million from Sequoia, Lehman Brothers and others over four rounds, most recently \$15 million in October 2007, according to Thomson Reuters (publisher of VCJ).
- Adbrite, an online advertising services company founded in 2004, laid off 40% of its staff. It has raised \$35 million from Sequoia, DAG Ventures and Artis Capital over three rounds, including about \$23 million in November 2007.
- And Jive Software, a 7-year-old developer of collaboration software for improving business productivity, announced that it would make an undisclosed number of layoffs. It raised a single round of \$15 million from Sequoia in August 2007.

At least one Sequoia-backed company has shut its doors. P2P media sharing company SkyRight raised \$19.4 million from Sequoia, Charles River Ventures and Velocity Interactive Group before shutting down in October.

Clearly, more layoffs and closures are coming. The only saving grace for venture capitalists is that the memories of what they did to guide their companies through the dot-com crash are still fresh in their minds.

The big question that no one has a good answer for is how long this downturn will last. Some, like Sequoia, say that the startup world should be prepared for a

1970s-style recession. Our best advice, then, would be to prepare for the worst and hope for the best.

PART 2: Fixing the VC-backed IPO market

Venture capitalists routinely take on things others dismiss as impossible. Just in the last few years, they've invested in companies pursuing breakthroughs in nuclear fusion, suspended animation and a cure for cancer.

Starting this fall, however, the industry has taken on what looks to some like an even more daunting task: reviving venture-backed IPOs.

It's an ambitious effort—and one whose prospects look to be deteriorating with the market downturn. The public stock offering, long the lifeblood of venture industry exits, has become increasingly rare.

Analysis of historical IPO data from Thomson Reuters (publisher of VCI) shows that the current decade has been atypically slow for VC-backed IPOs. The median number of annual VC-backed IPOs from 1970 to 2008 is 68, with an all-time high of 368 venture-backed offerings in 1986 and an all-time low of two offerings in 1975. Besides the Internet bubble year of 2000, when 265 venture-backed companies went public, only two other years in this decade have recorded more than 68 IPOs: 2004 (with 94) and 2007 (with 86). Six of the past nine years have fallen well short of the median, with this year being the worst. Just six VC-backed companies have gone public in 2008, with only one in the past two quarters combined.

Meanwhile, venture investors, long accustomed to waiting out market cycles, are getting nervous. It's easy to blame the broader economy, with the troubled financial services sector dragging down markets and prompting a massive government rescue effort. However, VCs aren't convinced even a market upturn will guarantee an IPO turnaround. "Anytime where the markets are lousy it's very bad for IPOs, but there's something worse than all this that's in play," insists Dixon Doll, general partner at DCM and chairman of the National Venture Capital Association.

Just what comprises "something worse" is a matter of some debate. Favored culprits include accounting standards-setters (for making rules too complex and cumbersome), big investment banks (for spurning smaller IPOs in favor of mortgage-backed securities) and the government (for multiple infractions, including Sarbanes-Oxley and a securities law enforcement record that's ranged from overzealous to alarmingly negligent.)

What's agreed, says Doll, is that any workable action plan must include some consensus on the cause of the problem. To that end, the NVCA is organizing four roundtables on the IPO crisis beginning this month. The meetings will include attorneys, investment bankers and stock exchange representatives, along with venture capitalists, all given a broad mandate to brainstorm ways to repopulate the VC-backed IPO pipeline.

In advance of that, however, venture industry stakeholders have been weighing in on the issue with a host of creative solutions—and some warnings on the consequences of both inaction and overreaction.

Crisis or not?

Notably, not everyone agrees that the current dearth of IPOs constitutes a crisis for the venture industry. A common view is that demand for new issues will eventually recover on its own. Another is that firms can and should concentrate on generating top-tier returns without taking a company public.

"It's a mistake for venture capitalists to be dependent on IPOs. It's never been the predominant or ideal means of exit," says Will Dunbar, managing director at early stage investor Core Capital Partners. He advises investing with the assumption that a portfolio company will end up in the hands of a strategic acquirer.

Todd Chaffee, a general partner at Institutional Venture Partners, says the IPO problem is "simply a cyclical issue. Venture-backed IPOs will be back once the markets stabilize. When institutional investors start looking for growth technology investments again, they will turn to the high-growth, high-margin companies that are backed by venture firms, and the IPO window will open again, probably in late 2009 or early 2010."

Those VCs who believe the situation has reached crisis proportions argue that there's a difference between few IPOs and no IPOs. While individual firms may prosper selling portfolio companies to strategic investors, many believe the venture industry won't succeed in the long term without access to public markets.

"IPOs are the river Nile of the venture business: No Nile, no life," says Venky Ganesan, managing director at Globespan Capital Partners. "Some would argue that M&A can make up the gap, but the problem is that M&As subsume innovative companies rather than letting those innovative companies subsume the legacy ones."

This logic is a bit like the chicken-and-egg conundrum. A vibrant IPO market is what enabled companies like Microsoft and Cisco to go public, get really big and then buy up lots of venture-backed assets with stock. Without a new issues market, Ganesan worries that today's startups won't have the chance to grow into the big acquirers of tomorrow. If the slowdown continues for many years, he warns: "We will have fundamentally undermined innovation in America."

Action Plan

So, what to do? Even among industry players who believe something can be done to reinvigorate the IPO market, there's far more consensus on what caused the problem than about how to solve it. High on the who's-to-blame list are lawmakers, institutional investors and investment bankers.

Given their stated priorities, if venture investors had superhero-like powers, the game plan might look something like this: VCs would fly into Congress, demand tax credits for public market investment in good-for-the-economy sectors like cleantech and life sciences, instill broad respect for the job-creating muscle of the venture industry and kill Sarbanes-Oxley with their cosmic death rays.

The heroes would then descend upon the headquarters of the Financial Accounting Standards Board and insist that standard-setters drop their nonsense about expensing stock options and mark-to-market valuations and institute a simpler set of accounting standards for small, entrepreneurial companies.

Finally, they'd convene a meeting of Wall Street's most powerful investment banks and institutional investors and use their mind-control powers to elicit a promise from both groups to make growth technology and biotech companies their prime areas of focus.

Sadly for fans of the quick fix, venture firms tend to be staffed more by MBAs and engineers than caped crusaders. In the real world, industry players call for more modest, slower-to-enact plans that rely on such non-superhero-like tactics as lobbying lawmakers, bolstering boutique investment banks, exploring new exchanges and deepening ties to institutional investors.

Increasingly, venture investors are concluding that the IPO market's failure to recover on its own from the dot-com downturn is the result of structural, as well as cyclical problems.

"After the tech bubble collapsed, there's not been an effective mechanism for mid-sized growth companies to take advantage of the public markets," says Cameron Lester, general partner at Azure Capital Partners. "The system has to be redeveloped, and there has to be a more cost-effective way for companies to fill the obligations of public companies."

Various approaches have been suggested to reinvigorate the IPO market. The four main suggestions are as follows:

1. Influence the Institutional Investors

At the top of the list of suggestions for fixing the IPO market is deepening ties between pre-IPO companies and buy-and-hold-oriented institutional investors. That's the idea behind Inside Ventures, a newly launched industry group based on Sand Hill Road that's looking to set up a series of meetings between executives of leading venture-backed companies and large asset managers. The basic plan is to create a forum where institutional investors can familiarize themselves with pre-IPO companies and do deeper diligence before committing to buying shares.

Institutional investors “have told us that being conservative investors, the one-hour road show is not conducive to making a long-term decision,” says Mona DeFrawi, founder of Inside Ventures. She says investors have expressed interest in meeting with companies that are looking to go public within six to 18 months.

DeFrawi says it’s crucial for newly public companies to attract investors who plan to hold on to their shares for a long period. While such investors typically were large buyers of IPOs, in recent years active traders have been buying more new issues. The result is highly volatile share prices.

“The [venture] investors can’t take a company public and then dump their stock the next day,” she says. “The new investors in an IPO don’t have that same requirement, so it’s important when you bring in your investors that they share your vision.”

DeFrawi says one option for getting large institutional investors primed to back IPOs is to offer them the opportunity to invest in both pre-IPO rounds and a public market offering.

To date, Inside Ventures has put together a 21-member board consisting of seven health care VCs, seven technology VCs and seven buy-side representatives, including both strategic and institutional investors. Board members include Doll and Sam Colella, managing director at Versant Ventures.

The group’s venture board members will review privately held companies nominated as strong IPO candidates. Anyone is free to nominate a company, and the ones viewed as most promising will be presented to institutional investors who are members of InsideVenture.

There’s no cap on the number of pre-IPO companies that can be presented, DeFrawi says. However, reviewers will impose stringent guidelines for companies’ financial performance and technological prowess. The group has not yet set a date for its first meeting.

While Colella says current conditions “look pretty bleak,” he’s encouraged that there is appetite from institutional investors, albeit perhaps not at the prices venture investors would prefer. That was the case for Fluidigm, a Versant portfolio company and developer of fluid analysis technology that had planned a September Nasdaq debut but withdrew in the wake of the Wall Street financial crisis.

Colella says efforts to better communicate IPO candidates’ stories to institutional investors will be particularly crucial for life sciences companies. These companies, which rely on IPOs to fund late-stage clinical research, have been particularly hard hit in the current downturn. In addition to Fluidigm, others pulling planned IPOs in the last two months include Aldagen, a developer of regenerative cell therapies, Codexis, a developer of biocatalysts for life science and chemical companies, and XDX, a developer of molecular diagnostic technology.

2. Insist on Fewer Rules, But More Punishment

Venture investors are also cognizant that to get more companies public, it must be cheaper both to launch an IPO and to meet continuing reporting requirements.

Doll supports efforts to convince accounting rule-makers to do away with one-size-fits-all standards and to allow smaller cap companies to provide simpler statements. This would cut down substantially on accounting and audit costs, which by his estimates can cost small companies close to \$2 million a year—enough to convince many that staying private is the more cost-effective option.

Sanjay Subhedar, managing director of Storm Ventures, notes that it’s not just the rules that matter, but how they’re enforced. He favors fewer rules, but stricter enforcement to maintain investors’ trust in markets. “I’d put CEOs in jail and ease up on regulation,” he says. “Regulation gives you a false sense of security. There are a few bad apples who do bad things, and if they knew that they couldn’t hide behind the rules and regulations, and that they had personal jeopardy, that would make corporate executives more likely to do the right thing.”

Others, particularly those who’ve had a portfolio company go through an options backdating investigation, wish authorities would lay off. Irwin Federman, general partner at U.S. Venture Partners, says regulatory zeal has

made entrepreneurs increasingly wary about taking on the risk of going public. “One of the worst perpetrators in this particular scene is the U.S. government,” he says.

The situation today stands in stark contrast to the bulk of his tenure in the venture industry, says Federman, who began investing in startups in 1978. “I can’t recall a time when the interests of investment bankers, attorneys, entrepreneurs and investors were more aligned,” he says. “The only professional group that is prospering under this environment is the accountants. Everybody else is sucking wind.”

3. Bring Back the Boutiques

Some say big investment banks share some of the blame for the tepid IPO environment.

“Bring back the boutiques. VCs need to make sure they cultivate and bring business to these smaller banks,” says Ganesan of Globespan. The boutique bankers that covered technology through most of the 1990s were ignored by VCs who went for the big brand investment banks during the bubble. This was a big mistake by VCs, depriving these boutique bankers of business and effectively shooting themselves in the foot.

“Bring back the boutiques” is a common rallying cry, one that is touted most vociferously by none other than the boutiques themselves. Paul Deninger, vice chairman of boutique investment bank Jefferies & Co., recently prepared a 45-slide presentation for NVCA members analyzing problems in the IPO market. A sizeable chunk of those pages was devoted to criticism of the five large investment banks that, until recently, controlled the bulk of underwriting for venture-backed offerings.

“My position, which doesn’t lend itself well to sound bites, is there’s an ecosystem and whole mindset around the tech IPO that was badly corrupted during the bubble,” Deninger says. “CEOs, VCs and bankers have sort of lost their way, and the ecosystem needs to be rebuilt, and a new set of firms needs to come in to rebuild that ecosystem.”

A key problem, Deninger says, is that the largest investment banks have not been interested in recent years in underwriting smaller offerings. That, he says, has led VCs to believe—incorrectly—that no market exists. In fact, he says, investors are interested in such offerings, and underwriters do want to take those companies public. However, the underwriters who want to handle such deal flow are smaller, boutique firms that specialize in that area.

In a way, it’s a throwback to what many VCs consider the Golden Age of the venture-backed IPO, that period in the pre-bubble 1990s when strong technology and life science companies went public with initial valuations around \$200 million. Those companies grew up to become market leaders such as Adobe, Cisco and Symantec.

Boutiques raise fond memories among VCs, too. Doll reminisces about the “four horseman”—Alex. Brown & Sons, Hambrecht & Quist, Robertson Stephens and Thomas Weisel. Boutiques have a particularly crucial niche considering that the IPO business in recent years has been more conducive to smaller players than industry giants seeking deals at massive scale. In the U.S., where underwriters typically get 7% of an offering, the total take added up to \$350 million last year for IPOs with initial market capitalizations under \$1 billion, according to Jefferies and Piper Jaffray.

IPO activity in Europe has been comparatively healthy. According to a report prepared by Jefferies and Piper Jaffray, Europe has recently averaged 60% of U.S. tech IPO volume while consuming one-sixth the venture capital investment. Since the beginning of 2002, the U.S. technology public company universe has decreased by 17%. Today, 69% of Nasdaq-listed companies have a market cap of less than \$500 million.

4. Modify the Nasdaq or Start a New One

Nasdaq also needs a makeover. Or a replacement.

One of the initiatives NVCA is looking at, says Doll, involves some of the U.S. exchanges exploring new specialized exchanges that would directly link buyers and sellers of venture-backed IPOs. The group is in talks with New York Stock Exchange officials about developing trading venues tailored to new issues,

particularly small cap deals. Nasdaq has also been progressing over the past two years on Nasdaq Portal Market, which handles sales of unregistered securities to qualified institutional buyers. Qualified buyers must have at least \$100 million of assets under management.

Transactions involving unregistered securities are on rise, according to Nasdaq. Secondary private transaction volume for unregistered securities in U.S. private companies increased approximately 140% to \$3 billion in 2007, as compared to \$1.25 billion in 2006, according to NYPPEX Private Markets, a Greenwich, Conn., firm that handles private securities transactions. New sources of liquidity included hedge funds, funds of funds and publicly traded business development companies.

Yet another possibility, says Ganesan, is to start a new Nasdaq. "Nasdaq was created as an alternative to NYSE, which was considered too stringent for technology companies," he says. "We might now need to create a new marketplace as a replacement for Nasdaq—a public market for small to micro-cap companies."

Dry Spell

Trouble is, the timing for an IPO comeback couldn't be worse. To revisit Ganesan's river analogy, efforts to revive the new issues market in the current liquidity crunch look about as likely to succeed as a Nile fishing expedition launched amid a record drought.

Between bailouts and financial firm failures, institutional investors have far greater worries keeping them up at night than the threat of missing out on the next big VC-backed tech offering. Executives at scores of venture-backed companies that filed to go public in the past year have since withdrawn. "I doubt that anyone today is planning their strategy around the likelihood of an IPO," says Dale Sander, CFO of Biolex, a clinical-stage pharmaceutical company that withdrew its IPO filing this fall in favor of a \$60 million venture round.

A common viewpoint is not that the IPO climate will change significantly, but that the VC industry will adapt to an environment with fewer public market exits.

Tracy Lefteroff, managing partner of the venture and private equity practice at PricewaterhouseCoopers, predicts that in a best-case scenario, the IPO market won't recover until 2009. Others who've been through the process say even that is optimistic.

When the window does reopen, PwC analysts predicted in a recent report, 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: There will be bigger IPOs, but fewer of them; VCs may become less likely to invest in capital-intensive and longer-to-maturity startups, and VCs may be positioned more as incubators of startups for large corporate acquirers and less as an IPO pipeline.

Venture firms are also likely to reorganize themselves to cope better with an environment of fewer public offerings and longer exit timelines.

"A number of financial investors are looking to buy majority stakes in established [private] companies that would have gone public 10 years ago," says Ian Sigalow, a principal with Greycroft Partners. "If this trend continues, I think you will see the venture industry gradually evolve into two groups: The first group will be smaller funds that manage under \$150 million and, like us, don't rely on an IPO to return the fund. The second group will be bigger growth funds that will routinely take companies public. They will have to invest further along the growth curve."

Sigalow says the whole rationale for going public has changed over the last few years. It used to be about access to capital markets for fund-raising, but now it is a need for a major liquidity event.

To bring public investors back in droves, VCs will need a more robust pipeline in place. Says Jake Seid, managing director of Lightspeed Venture Partners: "If you have less quality inventory when the window opens, by definition you'll see fewer IPOs."