

## Surviving the Drought

*VC-backed companies that have shelved their IPOs should expect the price of new rounds to go up*

By Alexander Haislip, Senior Writer

The credit crunch, oil prices, Sarbanes-Oxley and skittish investors. Call them the four horsemen of the IPO apocalypse.

It's bad. We didn't realize just how bad it was until we ran the numbers. Since the markets started trending downward last fall, a total of 32 venture-backed companies have withdrawn their IPOs, including 24 this year, according to data from Thomson Reuters (publisher of VCJ). That's nearly \$3 billion of planned public placements that didn't get done for companies that have collectively raised more than \$2.5 billion in venture capital, according to our analysis of the data (see table.)

As bad as that sounds, there's no need to panic just yet. There's lots of late stage money floating around, not only from venture investors, but also from hedge funds, venture lenders, mezzanine investors and private equity shops. Late stage financing deals are chugging right along, with about 600 done so far this year.

But just because the money is available doesn't mean it's cheap. With the S&P 500 off by more than 15%, late stage valuations are going to take a hit. A number of late stage investors told VCJ that companies looking for late stage cash will likely see less favorable term sheets.

Many companies, such as biometrics security company UPEK, are choosing to run at cash flow neutral until the market opens back up again. "We're conserving our cash so we can be ready for when this market turns around," says CFO Gary Martell. The company, which has raised \$47 million from VCs since 2004, filed to go public in May 2007 and pulled its offering this past March.

Martell says his early stage investors have been anxious to re-up their investments each time the company needed cash, but with \$72 million in 12-month trailing revenue and profitability, UPEK won't be likely to go back to the VC well again. Martell has his mind set on an IPO, he just doesn't know when. "I'm hearing a lot of people saying 2010," he says. "We don't focus on that. We just try to be ready when the market is."

Others, particularly life sciences companies still a ways a way from even getting sales, are turning back to investors for ever larger rounds. Consider drug-eluding stent company Broncus Technologies, which pulled its \$86.3 million IPO in June. The company went on to raise \$10 million in venture debt financing from Triplepoint Capital and is out to raise another \$30 million for its Series G financing, according to reports. Broncus has already raised \$80 million from VCs.

### Hedging bets

Few companies that have pulled their IPOs have run into difficulty so far, in part because there are a lot of firms considering late stage deals. Hedge funds, for example, launched dedicated venture capital funds during 2007. In the past, those investors would have run for the hills as soon as the market took a downturn. But because they've already set

aside the money they're looking to put to work—and hired a team to deploy it—most are still making investments.

Asset manager AllianceBernstein, for example, has maintained a steady investment pace, backing four companies in Series C, D and F rounds this year. It had backed 12 companies between late 2006 and the end of 2007. D.E. Shaw Group, another hedge fund that committed to venture capital investing in 2007, has backed eight companies so far this year, many of them in the later stages. At least one venture investor at a well known hedge fund says that the credit crunch hasn't affected his group. The group is as active as ever and actively pursuing late stage deals, he says.

Then there's another class of large institutions and firms anxious to put money to work, but cautious about getting wiped out in the public market. These groups are seeking out the investment bankers that run late stage auctions, people such as Peter Falvey of investment bank Revolution Partners. Revolution takes on late stage companies as clients and helps them raise large financing rounds. It did four deals in 2007 and will likely do eight this year, Falvey says.

The trick to getting the deals done is to shop them to institutions looking to deploy large chunks of cash. "We're getting a lot of interest in late stage deals, typically the bigger the check the better," says Falvey. "They're under a tremendous amount of pressure to put money to work and they've got a lot of foresight. The issuers in a lot of cases are getting very good outcomes. Even if the price is not cheap, they're getting into good companies and they'll have an exit down the road."

An example of the type of deal Falvey helps to get done is the \$18 million Series D investment for legal software maker PSS Systems in May. The existing investors—Azure Capital, Cipio Partners, Granite Ventures and Lightspeed Venture Partners—had most recently invested in the company about six years earlier with a \$21 million Series C. Falvey brought in growth investor FTVentures to lead the new round.

Scott Potter, managing partner of mezzanine investor San Francisco Equity Partners, says he has seen a lot more companies coming to his door since the credit crunch. "The businesses we get involved with typically could finance their growth with debt leveraged on EBITDA, but that's not as available for them as it used to be—or it's a lot more expensive," Potter says.

### Debt available, but pricey

As much as the big banks may have pulled out of debt financing, venture debt investors have seen an uptick in their late stage and growth business. "The supply of companies looking for venture debt has increased since the IPO market closed," says Triplepoint Senior Managing Director Dean Riskas. "We're seeing real solid opportunities:

life sciences companies looking to get to the next medical trial, or companies who were going to go public and adapt their product lines are looking to do it with more debt. If the IPO market is closed behind door No. 3, there's a good reason to look behind door No. 1 and door No. 2."

With both the demand for debt rising due to a closed IPO window and the supply contracting thanks to banks pulling back, Triplepoint has found itself in the cat-bird seat. Riskas says the firm has been able to charge more for its debt, he won't say by exactly how much.

"The larger deals feel more effects of the roiling of the credit markets than the smaller, early stage deals," he notes. Of course it's hard to say exactly how much interest rates on debt have increased since each deal is structured differently.

The one source of capital that will continue to be available with good terms and increases in valuation is from early and mixed stage VCs—the people who have already poured money into pre-public companies. Industry consolidation and a flight to perceived quality by limited partners have endowed some firms with more capital than they have ever had before. Some of this money goes to claim bigger stakes in portfolio companies as they mature, and it can be difficult for investors to rationalize a down round solely due to market conditions.

### Shave and a haircut

While there is plenty of cash available, it is likely to come with a higher price tag. Many late stage investors expect to see a "correction" in private company valuations, noting that it just makes sense when both the Dow and the Nasdaq are off by 15% since the beginning of the year.

"It wouldn't be surprising to me if we see a 40% to 50% price drop," says Bridgescale Partners Managing Director Rob Chaplinsky. He points to studies of venture capital term sheets by law firm Fenwick & West that show that 72% of all venture capital deals were up rounds during the first quarter of 2008. Compare that to 2003, he says, when 73% of all venture capital deals were down rounds. "We've been waiting for this type of correction to happen and we think things are going to become much more rational. A lot of the companies that are going out right now may see a 20% down round and that'd be okay," he says.

So it's a good idea to polish up that slide deck now to get while the getting is good. Valuations on late stage companies have some price stickiness, but that's about to get smacked back into perspective, late stage investors say. "This environment is similar to 2001, when you had a situation where the public markets had corrected and you actually had an inversion between the private market valuations and the public market valuations," says Todd Chaffee, a general partner at Institutional Venture Partners.

Relatively cheaper public market companies have prompted Chaffee and his IVP partners to pass on most of the private deals they've seen in favor of small-cap tech stocks in verticals they have experience in. Chaffee says IVP has been looking at public companies trading at valuations of 1x revenue and 5x EBITDA. Making an investment in a company like that is a no brainer. "Why would you pay 4x revenue on a private company that's not profitable and not as strong?" asks Chaffee. "I'd like to send a comp sheet and a calculator to everyone in the later stage market."

It's a common refrain from investors and bankers alike. "Being a sub-\$500 million market cap company is not a good place to be," says

Falvey of Revolution Partners. "There is a significant discount being applied to very small companies—there's no research, no liquidity and no trading."

It may seem crazy that private companies would be able to demand higher valuations than their public market comparables. But there's an easy explanation: VCs overpaid in early rounds and have yet to take a write down. "The biggest challenge for a lot of these companies coming back to market is that they may have come off some high-priced rounds and raised too much money," says Chaplinsky. "We went through the exact same environment in 2000 where we over-capitalized companies. When things soften up, you pay the price for that."

It will be a dramatic price to pay too, at least for some late stage companies. There are several fundamental changes in the late stage market that can make it harder for any company that's already deep in its rounds to get new funding. Late stage VCs aren't content to ride on the recommendation of prestigious early stage VCs anymore. You better bring a plan of action, preferably one that involves aggressive acquisitions or a way to cement your position as a market leader.

"Just trying to focus on the pre-IPO round? I don't see anyone doing that," says Index Ventures' Dominique Vidal. "It sounds very opportunistic—like you're rolling the dice, not building companies or leaders. You need to have a stronger thesis of investment."

Index, which raised a \$577 million growth fund at the beginning of the year, isn't doing any traditional late stage investing. The firm is looking to back roll-up plays. That's exactly what attracted Vidal to Bestofmedia Group. The French publisher's plan is to acquire key tech blogs and news outlets and leverage its relationship with big advertisers.

Bestofmedia had already bought and integrated popular technology site Tom's Hardware into its publishing empire, and the power a big publisher can have rolling up smaller niche publications became immediately obvious to Vidal. "These guys have an opportunity to consolidate the market," he says. In July, Index cut a \$35 million check to the company, its first institutional round of financing.

Even committed cross-over investors are rethinking their approach to late stage. Crosslink Capital, for example, invests in all stages across both private and public companies, which can be a big help when it comes to evaluating pre-IPO companies. The partners are trying to find companies that are built to be good long-term investments instead of quick flips or momentum plays. "If it's a later stage deal, we're looking for companies that could be great public companies," says General Partner Peter Rip. "Not just that they get public, but that they would be good public companies to own."

Clearly, if a company can afford to get by without raising a new round, it should just wait it out. But there aren't likely to be many companies on the sidelines. VCJ's analysis of S-1 statements from the 32 VC-backed companies that pulled their IPOs since last fall shows that about 90% of them have yet to reach profitability. More than likely, they're going to need to raise more money to get through the IPO drought—and they're going to have to pay a premium for it.