

Pensions & Investments

Weakened market and lack of bank support limit firms' ability to sell holdings

by Arleen Jacobius

A damaged IPO market has become a major roadblock for venture capital firms trying to cash out their investments in portfolio companies, industry analysts said.

The longer a venture capital firm holds an investment, the poorer the returns. Venture capital returns have been battered.

Venture capital lost 12.4% for the 12-months ended Sept. 30, down from a -0.9% return for the year ended Sept. 30, 2008, according to return data released last month by Cambridge Associates LLC's U.S. Venture Capital Index.

There have been only three venture-backed initial public offerings so far this year. This follows a sluggish 2009 with only 12 for the year and a dismal 2008 with six IPOs, the slowest year for venture-backed IPOs since 1975, according to the National Venture Capital Association and Thomson Reuters' data. All three 2010 IPOs cut their initial offering significantly.

The smaller end of the public markets — which are the majority of venture capital portfolio companies — is “going the way of the dodo bird,” said David Weild IV, senior adviser, capital markets, at accounting firm Grant Thornton LLP, Chicago.

According to Grant Thornton research, the median IPO of any kind in the first half of 2009 was valued at \$135 million. The median value of venture capital-backed IPOs in the first half of 2009 was \$144 million. Twenty years ago, a \$10 million IPO of any kind was not uncommon and was supported by banks that marketed the shares to investors, but today, banks can't afford to support stocks that will gain them only a cent or less per trade in fees, Mr. Weild said.

As a result, the “four horsemen” investment houses that historically supported the smaller end of the stock markets — Robertson Stephens, Alex Brown & Sons, Hambrecht & Quist, and Montgomery Securities — have gone out of business. The large banks that remain are interested only in promoting a new stock that will raise at least \$500 million or is a high-profile consumer brand name such as Facebook and LinkedIn, he said.

“At some point, stocks need support. They don't sustain themselves,” Mr. Weild said. “Consumer brand names don't get lost in the market and do better.”

Mark Heesen, president of the Washington-based NVCA, agreed that support by bigger investment banks has become a problem. Indeed, venture capital firms are split on whether they get the marketing support for their stocks from the big banks or whether it is better to go with a small boutique, Mr. Heesen said.

“There could be four horsemen again if venture capitalists would only use boutique firms and that has not happened,” Mr. Heesen said.

Some venture capital firm executives believe boutique investment firms can take companies public more efficiently, while others prefer big investment banks that have larger staffs and more capabilities, Mr. Heesen said.

Meanwhile, the median venture-backed IPO has been getting larger. From 1991 to 1997, close to 80% of the IPOs were smaller than \$50 million, but by 2000 the percentage was down to 20%, and last year, 14.8% — nine of 61 — IPOs were under \$50 million, according to Grant Thornton data.

According to NVCA data, mostly larger venture capital IPOs succeeded in 2009, with the average IPO offer at \$136.8 million, up from \$78.4 million in 2008 and \$120.1 million in 2007.

Those few that brave the capital markets are making adjustments, cutting back their share offerings. For example, last week, Anthera Pharmaceuticals Inc., a Hayward, Calif.-based drug manufacturer, went public after delaying the IPO one week and cutting the number of shares offered. It raised \$43 million, 35% less than the \$70 million it planned to raise when it filed to go public in September. Anthera's venture capital backers include VantagePoint Venture Partners Inc. and Sofinnova Venture Partners.

Ironwood Pharmaceuticals Inc., Cambridge Mass., which raised \$203 million in an IPO on Feb. 16, cut its share offering by 30%, and QuinStreet Inc., a Foster City, Calif.-based online advertising company, the first venture-backed offering this year, cut its initial share offering by 21% and took in \$674 million.

Acquisition as alternative

The weakened IPO market has led venture-backed companies to prefer being acquired over going through the hassle of a public offering, Mr. Heesen said. The time it takes to get a portfolio company to an IPO has stretched to an average of nine years from five or six years.

Tough times have also led to discord among venture capital firm investors, CEOs and company founders, Mr. Heesen said. These days, competing interests among venture capital firms that invested in the same portfolio company — and portfolio company executives — make it difficult to work toward a common goal.

One venture capital investor might need to exit the portfolio and distribute a portion of the proceeds to investors before it

can raise another fund, while another may favor delaying an IPO, and at the same time the portfolio company founder may want to sell the firm and its CEO may favor the public markets, Mr. Heesen explained.

Todd C. Chaffee, general partner, at Menlo Park, Calif.-based venture capital firm Institutional Venture Partners, said that his firm has 10 IPO candidates but, “We are conservative when we go out (into the public markets).” Mr. Chaffee said the firm waits until the portfolio company can show good ongoing quarterly growth.

“We have companies that have the scale to go out but not the predictability, and without the predictability, you should not be public,” said Mr. Chaffee, whose firm makes later-stage investments.

“We've had no problem because we invest in high-profile companies and are backed by good-size banks,” Mr. Chaffee said.

That doesn't mean that venture capital firms don't try. Some 38% of the companies that registered to go public are venture capital backed, said Maria Pinelli, Americas director, strategic growth markets, Ernst & Young LLP, New York. Over the past five years, 40% of IPOs and IPO registrations combined have been by venture capital-backed companies. Not all registrations result in IPOs. In the past 10 years, on average, 60% of IPO registrants have resulted in a public offering, according to Ernst & Young data.

Other venture capital firms have had to resort to road shows years before the portfolio companies are ready to go public to stimulate interest from institutional investors who they hope will be long-term investors, Mr. Heesen said. For example, Anthera took the unusual step of opening up its books to the public last year before it made its IPO intentions public.