

IT'S OPEN

IPOs are back and the supply of attractive startups is stacking up. Will the portfolio backlog diminish?

by Mark Boslet, Senior Editor

This year should be a good year for venture-backed technology IPOs, even if Facebook, Groupon, Zynga Game Network and Twitter don't decide to go public.

That may sound like an odd thing to say since these darlings of the social Web are stoking the current round of Internet fever with hopes of sky-high IPOs and Internet dreams of a Netscape-like excitement for everything online.

But the venture industry probably won't see such high drama unfold with their exits. A new IPO cycle has been building since last summer. But it is lesser-known tech startups setting the tempo. And it may stay that way for much of the year and perhaps early 2012.

"There have never been as many private technology companies of scale, with profits, and good growth prospects," says J. Sanford Miller, general partner at Institutional Venture Partners and co-founder of the investment bank Thomas Weisel Partners. "You've got an unprecedented supply of attractive companies."

This steady supply could offer the industry's its best run of exits in nearly a decade and bring a welcome dose of prosperity.

What's more, after years of flagging fund returns, a healthy, but not overheated, market could whittle down the enormous backlog of portfolio companies. It also could drum up new LP enthusiasm and help reverse declining fundraising.

But breaths are already being held. The first quarter of 2011 saw a respectable 14 venture-backed IPOs, a 56% improvement from the same quarter a year earlier and the strongest opening quarter for a year since 2007, according to the National Venture Capital Association (NVCA) and Thomson Reuters (publisher of *VCJ*).

But the pace will need to accelerate if IPOs are to top the 94 launched in 2004, the peak year during the new millennium, and set a new post dot-com high-water mark. There are signs activity is picking up. As of mid-April, about 50 U.S. VC-backed companies were filed with the Securities and Exchange Commission to go public. But the market has a lot of ground to cover.

Solid 2011

It's easy to see why 2011 is shaping up as a solid year for IPOs. Startups have had extra years to grow and strengthen. The median age of a venture-backed IPO company is now 10 years compared with less than five in 1999, and many of the companies coming to the market now have substantial revenue and customer accounts.

Companies are having good post-IPO track records. At the end of last year, the average 2010 technology IPO stock was up 42% from its offering price. As of late March, 11 of this year's 14 IPOs were trading at or above their offering prices.

With investor confidence on the rise, "the public market window has finally gotten over the 2008 and 2009 malaise," says Steve Eskenazi, an angel investor and former managing general partner at Walden Venture Capital. "The next 12 to 24 months should be great."

"I feel we're coming into a period that reminds me of the mid-1990s. There is significant investor appetite for IPOs."

J. Sanford Miller
General Partner
Institutional Venture Partners

There are many examples to support such a claim. Cornerstone OnDemand Inc., a 12-year-old startup with 480 clients and a reported \$46.6 million in gross revenue last year, saw its shares jump 46.7% on its opening day in March. Before going public, Cornerstone raised about \$41 million from such firms as Bessemer Venture Partners, Meritech Capital and Bay Partners, according to Thomson Reuters.

"It tells you there is an appetite for these companies," says Jeff Richards, a partner at GGV Capital.

Chinese stocks are contributing to the market's enthusiasm. Qihoo 360 Technology shot ahead 134% on its opening day and the browser-and-security company continued to trade high, despite posting only \$8.4 million in profit last year.

More feeding frenzies are expected. LinkedIn, which has a bigger name than most of this year's IPO candidates, is almost certain to do well on its first day. The social networking site (which still had not set a date for its IPO, as of *VCI's* deadline in late April) has 90 million members and posted \$243.1 million in revenue last year, up 102 percent. Profit came to \$15 million. The only drawback to the offering appears to be its dual-stock system.

Popular Internet music service Pandora Media Inc., which boasts 80 million listeners, \$55.2 million in revenue last year and fiscal 2010 losses of \$16.8 million, also should find a welcome reception when it launches. This is despite its decision to use more than \$27 million of its offering proceeds to pay accrued and unpaid dividends to preferred shareholders.

Pandora raised about \$65 million from investors, including Crosslink Capital, Greylock Partners and Walden Venture Capital according to Thomson Reuters. Another hot IPO is HomeAway Inc., the Austin, Texas-based, 7-year-old online market place for vacation rentals, which wants to raise \$230 million. Reported revenue in 2010 came to \$168 million, up 39.6%, and the company posted a net profit of \$16.9 million, before accumulated dividends and preferred stock discount accretion.

The company raised \$756 million from Austin Ventures, Redpoint Ventures, Technology Crossover Ventures and Institutional Venture Partners and others, according to Thomson Reuters.

Also worth watching is Kayak Software Corp., which in March updated its IPO prospectus to show 52% sales growth in 2010. The company was founded seven years ago and had \$170.7 million in revenue last year. Its investors include Sequoia Capital, Accel Partners, Oak Investment Partners and General Catalyst Partners.

Likewise, Fusion-io Inc. is expected to see strong interest in its offering. The 6-year-old Salt Lake City-based solid-state hard-drive company serves a hot market with clients such as Facebook, IBM and Hewlett-Packard. In the last six months of 2010, revenue came to \$58 million and the company had a net loss of \$8 million. The company raised \$115 million in venture funding from New Enterprise Associates,

Lightspeed Venture Partners and Accel Partners, according to Thomson Reuters.

Why companies such as Kayak and Fusion-io, which are far from household names, are defining the market is easy to understand: Facebook, Zynga, Twitter and Groupon don't need to go public. They don't need the visibility an IPO brings, and they don't need the liquidity.

Founders of Facebook, Zynga, Twitter and Groupon can sell shares in the secondary market. They also have access to private capital at favorable rates, if they need it.

Instead, their IPOs will likely be triggered by the 500-investor threshold, which the SEC is reviewing and could possibly modify. Companies that cross the threshold are forced to disclose financial information, and many choose to go public in the process. Early this year, Facebook said in confidential documents sent to investors that it anticipated crossing the threshold this year, implying an early 2012 offering is under consideration. If the threshold changes, the timing could, too.

Zynga, according to the *New York Times*, also won't consider floating stock until next year. And while speculation emerged recently that Groupon is in discussions with Goldman Sachs bankers for an IPO anticipated this spring, the company raised \$950 million in January. So it isn't in a hurry to raise money.

Backlog

Even if these big names remain on the sidelines, the IPOs currently underway could have an impact on the industry's health. That's because fund returns have been held back by the large backlog of portfolio companies yet to generate liquidity.

John Taylor, vice president of research at the NVCA, calculates about one-third of the value of active venture funds remains locked in portfolio companies that haven't exited. For each dollar venture funds raised between 1981 and 2009, \$1.08 has already been returned to LPs, he says. Another 45 cents of value is in the portfolio companies, he adds. Finding liquidity for these companies would have a quick impact on returns. From 2000 to 2009, the industry provided first time funding to an average of 1,279 companies a year, yet only an average of 5%, or 67, went public each year.

"We haven't been at 14% for a while," Taylor says.

Still venture firms are paying close attention to the improving market. Globespan Capital Partners—an investor in Zipcar, which went public in April—has one more portfolio company in registration: Glasshouse Technologies.

Another four to six companies could be ready to file within four to eight quarters, says Dave Fachetti, managing director of Globespan. They are profitable and growing at a 50% pace or greater, he says.

Clearly “we’re going to have a very strong 2011 for IPOs,” says Neeraj Agrawal, a general partner at Battery Ventures, and “I predict we’re going to have a pretty strong first half of 2012,” too.

Agrawal says that Battery has nine portfolio companies likely to IPO in the next 15 months, some of which have \$100 million or more in annual revenue that many observers see as the ideal benchmark for candidates. The IPO frenzy appears to be spilling over into cleantech.

“You’ll see some interesting companies filing over the course of the next few months,” says Alan Salzman, CEO of VantagePoint Venture Partners. “We are going to see a couple of bellwether companies go.”

The challenge for cleantech is that companies are generally younger and less mature, so an IPO for many in the sector is considered a stretch. By some estimates, only 100 or so cleantech startups in the United States are six years or older. Nevertheless, 2011 could see leaders in thin film solar, LED lighting and smart grid take the plunge, Salzman says.

“I feel we’re coming into a period that reminds me of the mid-1990s,” says Miller of IVP. “There is significant investor appetite for IPOs.”

There also appears to be some possibility of a bubble, especially if a Facebook or Zynga files.

Until then, what’s clear is that the industry is facing an opportunity it hasn’t seen in a number of years and one it badly needs.