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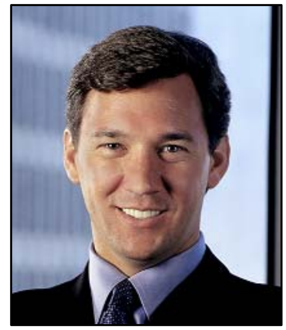
Bulking Up



Strong private companies are using stock and cash to buy other startups, hoping to build category killers that can weather a downturn

By Joanna Glasner, Senior Editor

Venture capitalists are feeling squeezed, and it's no mystery why. Portfolio companies are taking longer to exit. Credit's tight. Financial institutions are folding at a rapid rate. The IPO market's shut, and public acquirers remain scarce. Even for an industry accustomed to market cycles, the year is shaping up as a particularly brutal dry spell. The old mantra of "build a great company and the exit will take care of itself" seems to be in need of serious revision.

As the financial sector's perfect storm hammers down on credit and equity markets, VCs and portfolio companies are scanning the ravaged landscape for buying opportunities. They're finding a plentiful supply.

In recent weeks, high-performing private companies have been using stock and cash to buy other entrepreneurial startups in a bid to build category killers capable of both weathering a downturn and generating hefty profits. Smaller players, in turn, are getting absorbed into dominant rivals in the hopes of obtaining both a better chance of survival and a swifter path to exit.

"This is a classic case of when the market's tough, the strong get stronger and more acquisitive, and the weaker lower their prices," says Todd Chaffee, a partner at Institutional Venture Partners.

It's difficult to estimate the scale of private transactions involving venture-backed companies, as acquisition prices are rarely disclosed. Deal count is also tricky, as smaller acquisitions aren't always announced and many purchases are of strategic assets rather than an entire company.

Still, market observers say private-to-private deal-making is on the rise. Craig Jacoby, a partner at Cooley Godward Kronish, says he has handled a markedly higher volume of such transactions by venture-backed companies in recent months. "What used to happen in the private-to-private deals is that you'd have companies that just couldn't get enough mass on their own, and they'd find another company that didn't have mass," Jacoby says. "The big change I'm seeing these days is companies are going out and doing some buying purely for growth."

A number of factors have influenced the growth of private-to-private deals. Most notably, founders of target companies have grown more receptive to the idea of taking stock in another private company rather than waiting for an all-cash or public stock deal, an increasingly unlikely outcome in this dismal exit climate.

"Back in 1998, the bar was so low for going public, somebody might just take their chances," says Paul Holland, a partner at Foundation Capital, which has had four of its portfolio companies acquire or be acquired by other VC-backed startups in the past year. "Now, they need around $80 million or $100 million [in annual revenue] to do it, so it's logical and natural that there are more private-to-private transactions than there were 10 years ago."

Who's buying

There's no single sector that accounts for the bulk of rollups and strategic acquisitions.

In general, investments fall into two buckets. There are strategic acquisitions of companies with substantial assets and venture funding that are struggling or unable to exit in the current climate. And there are smaller transactions, generally involving bootstrapped, angel-funded, or Series A stage startups that are acquired by venture-backed companies seeking to carve out a dominant position in an emerging sector.

Zayo Group is an example of the first. The Louisville, Colo.-based company raised about $225 million in equity from investors including Battery Ventures, Centennial Ventures and Oak Investment Partners last year with a mandate to acquire owners and operators of fiber optic networks. Since then, it has bought nine companies, including, most recently, Columbia Fiber Solutions of Spokane, Wash.

John Scarano, Zayo's chief operating officer and co-founder, says the company's formation had a lot to do with market timing. Massive build-outs of fiber-optic networks nearly a decade ago left a huge oversupply of telecommunications capacity. With demand for capacity on the rise, founders saw the opportunity to buy assets at prices that were compelling for both buyers and sellers.

"The sellers of these kinds of assets—literally three or four years ago, these owners could not give away their assets," Scarano says. "Now that there has been a recovery somewhat in value there's arguably a window that's opened up, and many sellers are taking advantage of it."

From the buyer's perspective, assets have still not recovered in value to anything close to the replacement or original cost. That's attractive, Scarano says, because it provides a barrier to entry.

As of late August, Scarano estimated that Zayo had spent about two thirds of the capital it raised. By the end of the year, the company expects to be on pace to generate annual revenue of more than $200 million and EBITDA of roughly $60 million. He says equity investors have also verbally agreed to "materially increase" the amount of invested capital for further acquisitions.

Such sizeable strategic acquisition plays—with their focus on infrastructure and on companies that have previously raised large sums of capital—tend to occur most commonly in the telecom, semiconductor and software sectors. Others that have pursued such a strategy include Cortina Systems, a semiconductor developer that has made four acquisitions in the past four years, BPL Global, a software provider for electric utilities that has bought two venture-backed companies this year, and Coverity, a provider of source code analysis tools that has purchased two VC-funded startups.

Other serial acquirers are more focused on acquiring newer, smaller companies that have raised little previous funding, particularly in the Internet sector, where companies can be built for less than $1 million because of the proliferation of free or cheap software. Websites that have recently been snapping up entrepreneurial startups include Zynga, a developer of games for social networking sites that has acquired several gaming startups this year, and LiveUniverse, a network of entertainment sites backed by MySpace co-founder Brad Greenspan.

HomeAway, a network of websites that specializes in vacation rentals, has been particularly acquisitive. The Austin, Texas-based company, founded by Austin Ventures executive-in-residence Brian Sharple, set out to buy the largest and fastest growing sites in the market. To do that, the company has raised $231 million since 2004, most of it in the last two years, from VCs including Austin, American Capital, Institutional Venture Partners, Redpoint Ventures and Trident Capital.

Most of HomeAway's acquisition targets to date have been bootstrapped ventures, often run by a husband-a-wife team looking to retire, says Phillip Siegel, a general partner at Austin Ventures and a member of HomeAway's board. "In general, we tend to avoid companies that are venture-backed because the sellers tend to have unreasonable expectations," he notes.

Then and now

Today, venture-backed rollups and acquisitions are rarely about combining struggling startups. Generally speaking, that's viewed as a good thing among venture capitalists who recall hasty mergers of underperformers consummated in the wake of the dot-com bust. "It's like leaning two drunks against each other so they can stand up," says Jim Watson, managing director at CMEA Ventures.

Such strategies rarely work for venture-backed companies because they're notoriously bad at integrating acquisitions and holding on to talent, Watson says. "It's not like when it's Cisco buying a small company," he explains. "There you've got one large mother ship whose culture has been built to accept new things coming in."

Certainly venture investment history contains a few examples of rollups and strategic acquisitions gone awry. Among the most high profile is Solidus Networks, formerly known as PayByTouch, a developer of biometric-based payment systems that raised well over $200 million in venture capital and debt. By 2006, the San Francisco-based company had made six acquisitions in the payment processing, biometrics and loyalty marketing industries. But integration proved challenging and revenue forecasts had been overly rosy. Solidus filed for Chapter 11 bankruptcy protection in December and shut down its biometric payment and processing business in March, citing a lack of funding and poor market conditions.

Acquiring a rival also did little save the poster child of dot-com excess, pet supply retailer Pets.com. Before most backers could sell their shares from its 2000 public offering, the San Francisco company bought a languishing rival, venture-backed Petstore.com, in a move to consolidate the sector. The combined company closed its doors a few months later.

A strategic purchase also proved insufficient to keep cell phone service provider Amp'd Mobile out of bankruptcy. The company bought the development division of content publisher NINJA Mobile two years before its Chapter 11 filing last May.

However, flameouts don't tell the whole story. There are also plenty of successful, if obscure, cases in which rollups and strategic acquisitions by venture-backed companies have worked out quite well. IVP's Chaffee cites an investment in mobile messaging service provider Inphomatch. In 2004, the company merged with a rival, Mobileway, to form a new company, Mobile 365, which was acquired by Sybase in 2006 for $425 million. Previously, Inphomatch and Mobileway had raised more than $110 million in venture funding.

Jacoby of Cooley Godward points to a 2005 purchase of enterprise software developer Timestock by Wiley Technology, a Java developer. Wiley, which had raised $65 million in VC, sold to Computer Associates a year later for $375 million.

More recently, acquisitive venture-backed companies have enjoyed some significant up rounds, as well as exits. Zynga's last round of $29 million, raised in July, nearly doubled its total funding, and came with an even larger bump to valuation. The value of HomeAway and Zayo have also appreciated in the wake of their acquisitions, backers say.

Stock vs. cash

Another change is the frequency with which companies are paying for purchases with stock.

While cash purchases remain the preferred mode of exit for most entrepreneurs, venture capitalists say they're becoming more receptive to the idea of selling for stock in a private company. In part, this is a function of the fact that it takes longer—some eight years on average—to reach liquidity following initial funding. That makes it more tempting for a new startup to fold its assets into a private company that's further along.

"It's a fairly normal process where the larger fish in the sea start to swallow the smaller fish," says Foundation's Holland.

Speeding time to exit was one of the motivations for the sale earlier this year of Codefast, a portfolio company developing software lifecycle automation systems. It sold out to Coverity, a provider of source code analysis tools. Both companies were backed by Foundation. Coverity, founded in 2002, currently has revenue in the tens of millions and has been growing at a faster rate, says Holland (who notes that he abstained from voting on the transaction to avoid perceived conflicts of interest).

Stock transactions are often compelling to VCs, Jacoby says, because "it can be a back-door way to invest in the larger company by the investors in the smaller company." Investors in the acquired startup frequently wind up with board seats in the combined company, which also adds stature to their portfolios.

Bragging rights, however, are not usually part of the equation. Says Holland: "One of the downsides of doing a private transaction is we can't say we made five or 10 times our money because the private company is not yet liquid."

But fast liquidity is less of a concern for new and very small startups, says Mark Jacobstein, CEO of iSkoot, a provider of mobile VoIP services. "The four-person startup that doesn't have any revenue shouldn't really be thinking about how the IPO market isn't very good," he observes. Stock was a major component of the acquisition by iSkoot in September of SocialIM, a social network instant messaging platform. "There was no arm-twisting necessary," Jacobstein says of negotiations for the purchase.

Nonetheless, a common drawback to private-to-private stock transactions is that it's often difficult to agree on valuations. "You have entrepreneurs on both sides who have fairly lofty valuations on their stocks, and they tend to be good storytellers," says Jacoby. Companies also often have preferred and common stock with different values, adding another layer of difficulty.

For those reasons, many serial acquirers prefer the comparative ease of paying cash or mostly cash. At HomeAway, acquisitions so far have been paid for mostly in cash in part because entrepreneurs are more receptive to selling, says Austin Ventures' Siegel. Additionally, most of the acquisition targets were already profitable, making illiquid private stock less attractive.

Another approach is to start with cash purchases and then use equity as currency once the company has reached critical mass. That's the general plan at Zayo, says Scarano. The company has made its acquisitions in cash so far, but expects to be able to use equity for future acquisitions, perhaps beginning in the next couple of quarters.

Exits, anyone?

The chief danger of growth-by-acquisition strategies can be summed up in the old cliché: The bigger they are, the harder they fall. By merging rivals in an attempt to create market-dominating companies, VCs run the risk of alienating talent or missing out on organic growth opportunities as a result of shoddy integration. Moreover, in the public markets, highly acquisitive companies show mixed results, ranging from legendary successes, such as Cisco's rise in the late 1990s, to fabled flops, like Time Warner/AOL.

Still, for companies with scant likelihood of a near-term exit, the lure of linking up with a prominent competitor may be hard to resist.

"It's a phenomenon related to a lot of companies chasing the same market. If you're not No. 1 or No. 2, it becomes infinitely more difficult to crack through," says Rob Ward, a managing director at Meritech Capital Partners and board member at Proofpoint, a provider of messaging security systems that bought Fortiva, a provider of e-mail archiving tools, in June.

That said, it has always been easier to buy a company than to build one. And either one is a lot less difficult than selling at a profit. As buyouts legend Henry Kravis once observed: "Don't congratulate us when we buy a company. Any fool can buy a company. Congratulate us when we sell it and when we've done something with it and created real value."

By that measure, the celebrations for the latest wave of VC-backed rollups and strategic acquisitions will have to wait.