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Private equity set to reshape venture capital industry

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By Constance Loizos

Private equity firms, already reshaping wide swathes of American business, are poised to begin shaking up the venture industry, too.

In a new survey of venture capitalists' 2007 predictions, 71 percent of the 200 individuals polled by the National Venture Capital Association said that selling their startups to these giant buyout firms may become an "attractive option" next year.

It's a dramatic shift; the worlds of venture capital and private equity have rarely interacted.

Private-equity firms typically buy mid-size to large companies -- public or private -- with an eye toward selling for at least twice their initial investment within a few years, while VCs mostly invest in nascent, unproven companies, hoping for bigger payoffs on smaller investments.

But venture investors have been overshadowed by ever-ballooning private equity firms and believe it's inevitable that some of the capital sloshing around the buyout world will find its way to them.

According to Dealogic, a New York-based outfit that tracks M&A activity, private equity firms have so far this year spent \$376 billion to purchase 766 firms in the United States, the vast majority of which have been privately owned companies. The figure is roughly three times the \$129.6 billion that private equity firms shelled out last year to acquire 721 companies.

“For firms like mine, it's great,” said Charlie Rothstein, a venture capitalist with the investment firm Beringea, which has offices in Detroit, London and Los Angeles. “My options used to be to sell to the trade,” meaning to acquisitive companies like a Google or Computer Associates, “or to try and take a company public.”

IPOs had long been the preferred way to “exit” venture investments, but VCs say that taking a company public has become more difficult, largely owing to tougher SEC regulations.

“Now, with this massive population of buyout funds scratching around for any deals they can find, we're all going to start benefiting,” said Rothstein.

Or so they hope. In truth, VCs have little choice but to look for new ways to sell their companies right now. Not only is the IPO market all but shut, the Googles of the world are interested in only a fraction of the venture-backed companies looking to be sold.

Venture capital firms also face the curse of history. “VC businesses may be the hottest new things,” said one prominent buyout manager who asked to remain unidentified, “but it's hard for them to gain traction” because so much of Corporate America was burned after the go-go '90s.

“VCs are at a crossroads,” said NVCA president Mark Heesen. “They are seriously looking at buyouts as a potential way of extricating themselves from some of their companies.”

The extent to which private equity and venture capital may begin colliding remains in question. Rothstein points to Beringea-backed Mergermarket, which attracted eight potential bidders earlier this year, half of which were buyout firms, according to Rothstein. The company, which had raised \$12 million in venture capital, ultimately sold in August to the international education company Pearson for \$192 million, giving Beringea 18 times its investment. But it might have collected less without the private equity interest.

“Even if a private equity firm doesn't buy one of our portfolio companies, they're in there, stirring up trouble and increasing the (sale) price,” said Rothstein.

Another VC on Sand Hill Road said to expect yet a different approach on the part of private equity firms, suggesting they may begin to “roll-up” venture-backed companies.

“A lot of companies are doing OK but can't go public on their own,” said the VC, who asked not to be named because of his firm's current negotiations with two private equity firms. “If we as VCs try to merge them, it's not going to work because VCs and founders have their own agendas. But a private equity firm can come in, buy the companies, and merge them, and hopefully create something more valuable.”

Clickshift represents yet another way that venture-backed companies might be acquired by private equity firms. Earlier this month, the online marketing startup was bought by Webtrends, a company that analyzes Web site behavior. The catch: Webtrends is itself owned by Francisco Partners, a Silicon Valley private equity firm that paid \$94 million for the company in March 2005.

ClickShift CEO John Rodkin said that ``when Webtrends talked to us ... the model we discussed was almost like a big pharmaceutical company that doesn't develop new drugs itself but buys companies that've had successful clinical trials. I think the idea (for Francisco Partners) was to go buy a big company with a huge distribution channel, then let VCs fund new technologies, and later merge them into that channel."

"It's something we may see more of," said Glover Lawrence, a managing director of Boston-based McNamee Lawrence, an investment bank that focuses on technology M&A. ``If you can take (companies) private, pare down expenses, then add selective acquisitions, then you can grow them again and take them public again, potentially for a windfall."

Whether VCs will benefit is another thing entirely. Rodkin didn't disclose ClickShift's purchase price, saying only that its sale ``provided a good outcome for everyone," including ClickShift's venture investors -- El Dorado Ventures and U.S. Venture Partners -- which put \$6 million into the 18-month-old company.

Glover suspects VCs may have less to celebrate than they think, pointing out that private equity investors can be very disciplined buyers.

``Private equity firms are going to buy those smaller companies for as low a price as possible."