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Mergers & acquisitions: Valley's shift from IPO to M&A

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By Constance Loizos

A surge of mergers and acquisitions has reshaped the Silicon Valley landscape at the same time that fewer companies are launching initial public offerings.

Is that bad? At least one prominent investment banker thinks so, saying those trends could spell trouble for the region.

Paul Deninger, vice chairman of investment bank Jeffries & Company in Boston, believes that Silicon Valley is unwittingly sabotaging itself by "snatching up acquisition checks" rather than growing companies into big-league businesses.

Fewer stand-alone public companies translates into fewer challengers to incumbents, he argues, and that may hamper innovation. "The reason that oil and automotive industries operate the way they do is that there aren't any real challengers to their ways of doing business. The same is becoming true of Silicon Valley companies (that buy promising technologies); they're buying up smaller outfits before they become more serious threats."

Fewer public companies According to industry tracker VentureOne, 40 venture-backed Silicon Valley start-ups were acquired in the first quarter of this year, compared with 53 in all of 1997. Meanwhile, the region's pool of publicly traded companies is shrinking. In 2000, Silicon Valley was home to 417 companies. Last year, the number dropped to 280, down by 17 from the year before, with 12 companies merged into other publicly traded companies.

Deninger attributes the increased number of M&A deals vs. IPOs to Wall Street's fee structure. Large investment banks like Goldman Sachs and Credit Suisse First Boston, where many venture firms go in the absence of smaller outfits like Hambrecht & Quist that once catered to them but were themselves eventually acquired, push firms into deals because the IPO route takes longer.

"Private equity firms generate fees of hundreds of millions of dollars a year for investment banks," Deninger said. Venture firms, he said, "might generate fees of \$10-to-20 million (for an IPO). So where do you think bankers are spending most of their time and attention?"

Though Deninger has his own interests - Jeffries & Co. advises venture firms and small companies - the slim numbers of new IPO issuers is also of concern to Frank Quattrone, once the world's most powerful technology investment banker, who noted at a recent Palo Alto luncheon that over the past six years, M&A has dramatically outpaced the number of IPOs.

Quattrone said one reason for the shift was that the Sarbanes-Oxley Act, though "well-intentioned," may "have gone too far in certain areas."

Others, such as Steven Fletcher, a managing director at the investment bank Savvian Advisors in San Francisco, said the shift could also be attributed to institutional investors, which have grown less enthusiastic over the stocks of smaller, and thus less liquid, public companies.

Still, not everyone sees the local environment as starkly as Deninger. Fletcher calls the IPO market "more discerning."

More cautious IPOs Meanwhile, Glover Lawrence, managing director of the tech-focused investment bank McNamee Lawrence in Boston, offers that "there's a strong argument that the absolute number of IPOs is lower than it was in the '90s because the '90s saw an explosion of companies that shouldn't have gone public."

John Drew, a venture capitalist with Technology Crossover Ventures in Palo Alto, further adds that while deep-pocketed private equity firms are "adding pressure to the system," it has "always been the case that banks have stronger relationships with companies that will buy multiple companies than with a company that might go public, then have a secondary offering 18 months later." In short, fewer transactions equal fewer fees.

Besides, much of the decision-making boils down to economics. It's not lost on start-ups that all the time they're burning capital, they're lowering their potential return. Said Brenon Daly, a financial analyst at the San Francisco consultancy the 451 group, "Think of it this way: Why would a start-up write a check to establish sales channels and write marketing materials when it can piggyback off the sales and marketing and distribution resources of a larger company?"

Indeed, Lawrence said many start-ups don't have a choice in opting for M&A. "After being burned (by start-ups) in the bubble, major corporations have become increasingly less willing to buy new solutions from untested vendors. When Citibank wants to cut the 3,000 companies it works with to 300, guess who loses?"

That's saying nothing of how eager some companies are to cash out what they can because, frankly, they're exhausted by the higher threshold required to take companies public today. Venture capitalist Promod Haque of Norwest Venture Partners in Palo Alto said it's a scenario he sees often.

"Sometimes, the management at a company has been around for seven to 10 years, and they're restless. They've been with the company too long and want to do something else." In fact, he said, many sales go forward not because VCs want to sell companies but "because management is disappearing. You have to protect your investment."

M&A's upside The good news, said Drew, is that M&A often yields wealth and other benefits, including freeing up entrepreneurs to move on to other companies.

Whether that's a big enough upside to make up for the decline in the number of public companies now operating out in Silicon Valley remains to be seen, but Paul Madera, a venture capitalist at Meritech Capital Partners in Palo Alto, is optimistic.

Madera, formerly a banker himself at Montgomery Securities, points out that several recent IPOs, including some in which Meritech has invested, are performing well. "Riverbed Technologies and BigBand Networks and a variety of other companies have all been trading up nicely, and that's been great validation across the valley," he said. Added Madera, "I'm personally encouraged, and I think every company that's related to those spaces looks at them and says, 'Hey, I can do that, too.'"