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Survival Of The Fittest: Bubble Cos. Pile Up At Exit

By Russell Garland 5/7/2007
(Editor's Note: This story kicks off an upcoming series in VentureWire on tech bubble survivors. Over the coming weeks, look for in-depth profiles on prominent venture-backed companies originally funded in the 1999/2000 timeframe.)

The debut of BigBand Networks Inc. (Cedar I Portfolio Company) on the Nasdaq Stock Market in March was welcome news for venture investors, eager for signs that the public markets are again a reliable source of liquidity. Not only did the network technology company's shares shoot upward 31% on the first day of trading, but they continued to perform well -- up 45% as of May 4. BigBand holds another distinction. It is one of a select few of the thousands of companies VCs initially financed in the bubble years of 1999 and 2000 to go public. And it could be in the vanguard of a wave of bubble survivors that are about to make good. "There's a bunch of BigBands," said Paul Madera, a managing director of Meritech Capital Partners, a later-stage venture firm and BigBand backer.

Nonetheless, the high number of venture-financed companies guarantees that competition for good exits will be fierce. The bar for companies seeking to go public remains high and corporate acquirers are driving hard bargains. Venture firms backed 4,757 companies during the hectic years of 1999 and 2000 but only 128 of them, or 2.7%, have staged an initial public offering, according to Dow Jones VentureOne. A much smaller venture industry financed 341 companies for the first time in 1992 and 106 of them, or 31%, have gone public. VentureOne is a research unit of Dow Jones & Co., the publisher of VentureWire. One reason for the low percentage of IPOs by 1999- and 2000-vintage start-ups is that overheated markets collapsed before many of them could even launch products. The meltdown took a high toll. Nearly 38% of the companies that got their first venture capital in those years went out of business -- but not before getting a total of $35.6 billion in equity. Another 30% have been acquired, some for attractive prices but many for less than the amount VCs committed.

But that still leaves plenty of bubble survivors in venture firms' portfolios -- a total of 1,422 as of late April, according to VentureOne. Three-quarters of them are in information technology or consumer and business services sectors. These 1,422 companies have received a total of about $50 billion in venture capital and employ more than 150,000 thousand people. Moreover, one-third of them are profitable.

The bubble companies, as well as some initially financed after 2000, are creating a wave of excitement among venture investors and investment bankers, who see a steady flow of IPO candidates this year and next into a receptive market. "I think greed is returning and fear is subsiding," said Jan Haas, president and co-founder of Velocity Financial Group Inc., a new venture and middle-market lender.

Some venture investors, however, still worry that accounting requirements of the Sarbanes-Oxley Act are making it too difficult for small private companies to make the leap to public markets in the U.S. The Securities and Exchange Commission is preparing to ease some of the rules, but venture industry leaders say the changes might not be enough and they will have to seek legislation. Spotty analyst coverage for small companies is another concern of VCs. "The problem is research," said Robert Grady, head of Carlyle Group's venture unit. "There's no economics in it for the banks."

M&A will remain the chief exit for venture investors. Even a robust public market won't be able to absorb all VCs have to offer. Last year, 416 venture-backed companies were acquired while 56 went public. The most venture-backed IPOs in a single year was 250 in 1999.There were 13 venture-backed IPOs in the first quarter of this year, the same number as in the first three months of 2006.

Companies registering for IPOs routinely draw closer scrutiny from corporate acquirers. VCs hope that a stronger public market for their companies will force acquirers to pay higher prices, and there are already signs of this. The median acquisition price of $105 million in the first quarter was double that in the last quarter of 2006, reaching its highest level since the first quarter of 2000. Even so, big technology companies such as Cisco Systems Inc. and Microsoft Corp. have a lot of leverage, said Michael Greeley, a general partner at IDG Ventures Boston. "They just drive these companies down in an M&A process," he said.

But the clock is ticking for the bubble survivors. Venture funds are typically 10-year affairs and investors will be looking for ways to exit from companies they backed seven or eight years ago. Companies that can't go public or find a suitable corporate acquirer might wind up getting sold to other private equity firms, although examples of this so far are limited. "The more alternatives you can create for your exit, the better your exit is going to be," said Dixon Doll, a founder and general partner at DCM.