

Surge of VC exits via buyouts is wishful thinking

By Joanna Glasner

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Faced with a tepid IPO market, some venture capitalists hope to find exits by selling portfolio companies to cash-rich buyout funds. More than 70% of the VCs surveyed in December by the National Venture Capital Association said they believe such exits will become a more attractive option in 2007.

Don't bet on it. Buyout firms may be promising suitors for the tiny portion of VC-backed companies with predictable cash flow and earnings, but they're unlikely to employ massive leverage to snap up development stage startups. It is more likely that VCs and buyout shops will team up to finance spinouts, but even those sorts of deals are few and far between. That is the consensus from more than a dozen interviews of venture and buyout funds by VCJ and sister publication Buyouts magazine.

"We as humans search for patterns where none exist," says Patrick Ennis, managing director at ARCH Venture Partners, regarding the likelihood that buyout firms' rich coffers will lead them to VCs' doors. "There's a reason why venture capital emerged as a big asset class, and why buyouts emerged as a big asset class."

Still, there are certain VC-backed companies that may appeal to buyout pros, including late-stage investments, rollups, and those rare venture-backed companies with predictable revenues and profits.

So says Michael Stark, general partner and co-founder of Crosslink Capital, which invests in early stage companies and mature businesses viewed as turnaround candidates. Crosslink sold one of its investments in the latter category—a stake in sales training company Miller Heiman—to New York private equity firm Leeds Weld & Co. in 2005. Stark declined to reveal the purchase price, but says the terms were favorable to Crosslink. In his current portfolio, Stark views a turnaround investment in utility billing company NWP Services as another potential target for a buyout fund that sees upside in its "very predictable revenue flows."

Stark envisions buyouts eventually accounting for about 10% of Crosslink's exits, compared to virtually none a few years ago. IPOs and strategic sales are still the preferred paths to liquidity, but for companies with reliable cash flows that are too small to easily shoulder the cost of going public, buyouts will be an increasingly attractive option.

Just don't expect buyout firms to pay the kinds of multiples venture funds are accustomed to, says Jeff Drazan, co-founder of Sierra Ventures who migrated to the LBO space with \$250 million growth stage fund Bertram Capital.

"The fundamental problem with buyout guys buying VC-backed companies is buyout guys are looking for earnings," says Drazan. Buyout firms are looking to pay 6 to 10 times earnings, while venture capital firms are looking for 6 to 10 times revenue in an exit.

Blech for tech

Industry focus is another issue for venture funds seeking LBO exits. Buyout investors have sound reasons to avoid most of the technology sector, given the rapidity with which products become either obsolete or priced with the thinnest of profit margins. The few private equity firms that do specialize in tech, most notably Silver Lake Partners, Francisco Partners and Garnett & Helfrich, have concentrated on corporate spinouts and taking public companies private.

Those tech buyouts, while not numerous, have been pricey. The privatization of embedded chipmaker Freescale Semiconductor last year by buyout firms Blackstone Group, the Carlyle Group and HarbourVest Partners cost \$17.6 billion. Silver Lake spent \$1.2 billion taking Serena Software private in 2006 and also covered part of the \$11 billion bill for the buyout of SunGard Data Systems in 2005.

But none of the largest tech buyouts have put money in the pockets of venture funds. Nor is tech a top choice among most active buyout funds. Technology and software deals accounted for just 8% of LBO transaction volume in 2006, according to research by Buyouts.

Health care, another sector with a broad supply of VC-backed startups, accounted for 7% of buyout transaction volume in 2006. There again, dealmakers focused more on established providers than on emerging medical technology companies. Much of last year's buyout spending was concentrated in a single deal: the \$33 billion purchase of hospital operator HCA Corp.

LBOs of venture-backed firms remain a rarity, with only a handful transpiring in the past year. One involved Atlanta-based Agentis Software, a developer of business process management tools that had raised \$25 million in venture funding since 2001. Company executives orchestrated a management buyout in September backed by private equity firm Modena Technologies Capital Partners. Terms of the agreement were not disclosed

Sterling, Virginia-based N.E.W. Customer Service Companies, which runs warranty and repair services for retailers and manufacturers, was another target. In August, two buyout funds, company managers and venture investors orchestrated a \$520 million LBO of the 24-year-old firm, which had been purchased by St. Paul Venture Capital two years earlier.

In the hot solar sector, investor group GFI Energy Ventures purchased GT Equipment Technologies, a designer of products for the photovoltaic industry, for an undisclosed sum in early 2006. Prior to the LBO, the Merrimack, N.H.-based company had raised \$5.5 million in early stage funding.

Still, a few isolated cases don't make for a trend.

"I would love to have buyouts firms stepping into this breach and saying 'I will buy your firm lock, stock and barrel.' But I don't see that happening," says Drew Lanza, a general partner at Morgenthaler Partners. "They focus on metrics like EBITDA, and we don't."

Hybrids

But while the LBO won't become the new IPO, venture and buyout investors may find mutually lucrative opportunities in other complex deals.

One option for venture funds is selling startups to LBO-backed companies, says Scott Elliott, a partner with Ropes & Gray in San Francisco. Elliot points to December's acquisition of KNOVA Software, a developer of customer service tools, by M2M Holdings, a private company jointly owned by Battery Ventures and Thoma Cressey Equity Partners. The deal didn't directly involve venture backers, since KNOVA, a former Norwest Ventures Partners and Sofinov portfolio company, is now publicly traded. Nonetheless, Elliot says it's probable the same transaction structure will provide exits for private, VC-backed startups, as companies backed by buyout funds step up as strategic buyers.

Mike Devlin, a managing partner with growth capital firm Pharos Capital Group, predicts the pace of acquisitions by LBO-fund-backed companies will pick up as buyers look for quick ways to accelerate revenue growth. But he doesn't expect companies to acquire venture-backed startups through debt-intensive buyouts. LBOs work for buying companies that generate enough cash to repay the debt used to purchase them. Conversely, VC-backed startups—which focus on growing long-term revenue at the expense of short-term profits—make poor LBO candidates.

In fact, the profiles of an attractive venture investment and an appealing LBO candidate couldn't be more different. A buyout fund financing investments with debt has no place for a profitless semiconductor startup, regardless of how promising its technology may be. By the same token, venture funds don't take interest in the kinds of mature, slow-growth retail and services businesses popular with buyout firms.

But the two assets classes share common ground in late stage investing, says John Hogan, an investment banker at Piper Jaffray, one of the most active equity underwriters for technology deals. Buyout funds (which typically finance deals with three-quarters debt and one-quarter equity) are upping the equity stake to pursue investments in growth

companies. Venture funds, meanwhile, are allocating larger sums to invest in more mature companies. For example, Bridgescale Partners and Sequoia Capital have raised new growth funds in the past year and Draper Fisher Jurvetson is in the midst of raising its own.

VCs also expect to see increased competition from other alternative asset classes in 2007. In the NVCA's December survey, 67% of those polled said the venture capital industry will more intensely compete with hedge funds for deals, while 48% said they believe there will be more competition from buyout firms.

Teamwork

There's room for cooperation too. One scenario ARCH's Ennis envisions involves buyout funds and VCs collaborating to spin out divisions of larger companies. Venture investors could bring their technological know-how, while buyout shops could offer expertise in structuring complex transactions.

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It could work the other way, too. A VC-backed company could buy a division of a larger firm, thus becoming a profitable, industry-leading venture. Such a strategy holds appeal for VCs looking to beef up portfolio companies to thrive as standalone businesses until the exit climate improves.

Of course, there are drawbacks to orchestrating rollups for venture-backed companies. For one thing, they're incredibly time-consuming and complicated, says Morgenthaler's Lanza. He got a taste of what doing such a buyout was like this summer and concluded it wasn't any fun.

The deal took shape last summer when Intel—which has been spinning out non-core assets as part of its broad restructuring—approached Morgenthaler portfolio company Cortina Systems about purchasing its optical networking business. Lanza, a Cortina board member, arranged the transaction, collaborating heavily with Morgenthaler's buyouts arm.

In the end, venture investors put up \$115 million to purchase the Intel unit with no debt. It was, by Lanza's estimate, the largest single round for a Silicon Valley semiconductor company. It was also hard work.

"The Cortina transaction was on the outer boundary of my intellectual capability," Lanza quips. In addition to the financial arrangements, there was the challenge of integrating the two companies, a responsibility largely carried out by Cortina's management team. Since Intel's optical networking business operates in 120 countries and has 12,000 customers, it was no simple task.

Still, Lanza doesn't rule out the possibility of more buyout-type transactions on the future agenda for portfolio companies. For the moment, however, he's doing the kind of work more commonly associated with VC.

"Now I'm wandering the halls of Stanford looking for the professor with two smart graduate students," he says. "That's more fun." Mark Cecil, Managing Editor of Buyouts magazine, contributed to this story.

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