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TOP NEWS

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Is There an Innovation Drought?

Venture capital firms are having a hard time selling their companies. That may lead to less investment in breakthrough innovations

Broadbus Technologies was no bubble baby. Fast-growing and cash-flow positive after absorbing $57 million in venture capital investment to develop servers for cable companies' video-on-demand services, it had the look of what was considered a company ready for an initial public stock offering, even by the rigorous standards of the early 1990s.

But this year, as the board considered whether to go public, directors hesitated: They didn't know whether institutional investors would take the risk that Broadbus could compete with bigger companies. And the venture backers didn't want to put even more money into the Boxborough (Mass.) company since the prospect of an IPO was murky at best.

The solution is one ever more startups are choosing: Broadbus sold out. On Sept. 8, the company agreed to be acquired by wireless giant Motorola (**MOT**) for a price reported to be $186 million. Motorola spokesman Paul Alfieri says the deal will let Broadbus products be integrated into a broad vision of delivering on-demand video anywhere a consumer goes, and will give the little company a global scale it couldn't achieve otherwise.

But Todd Dagres, a venture capitalist and former Broadbus director, is skeptical. He worries that a whole list of potential innovations will get lost after the merger, as Motorola sheds some smaller projects and key talent leaves the company. "I know a lot of things that would have been added [to Broadbus products] if the market leader could have gone public," says Dagres, who invested in Broadbus at Battery Ventures and is now a partner at Boston-based Spark Capital. "It could have been a powerful U.S. company, but instead Motorola acquired it [and] there will be less innovation than there would have been if they had gone public."

IPO DROUGHT. Broadbus is hardly alone. In the third quarter only eight venture-backed companies managed to go public, according to data just released by the National Venture Capital Assn. Only 37 startups have managed to go public all year in the U.S.—the fifth bad year in the last six, interrupted only by the Google (**GOOG**)-dominated 2004.

The M&A market is slow for startups, too. The NVCA reports that there have been only 269 mergers this year, with an average value of only $100 million. That means 2006 is likely to be the slowest or second-worst year for startup mergers since the prebubble era. And prices are so low that venture investors lost money on 38% of the companies involved in mergers. "If young companies don't have the leverage of going public, the merger values are going to be lower," says Jim Gauer, managing partner at Palomar Ventures in Los Angeles.

A much bigger concern: The tough market for venture exits may be starting to stifle innovation. In particular, VCs increasingly admit that they are avoiding investments in higher-risk technologies in areas like semiconductors, where they would have to put up larger amounts of money to build companies that are likely to command ever smaller valuations on public markets.

SITTING ON THE SIDELINES. Instead, they say, they are settling for smaller investments in companies that are working within the framework of existing technologies, trying to add new features to today's products rather than making big leaps that will make competitors' gear obsolete. And that caution, they insist, is likely to hurt the broader economy. "If you're doing a brave-new-world investment, the IPO market changes the risk-reward equation enough that you probably don't do the deal," says Gary Morgenthaler, managing partner of Morgenthaler Ventures in Palo Alto, Calif.

Small companies themselves are also investing in technology more conservatively, trying to avoid a step that will take longer to pay off than public markets or acquirers would stand for. At eBags, an $80-million-a-year luggage e-tailer in suburban Denver, marketing Vice-President Peter Cobb says the pressure of weak financial markets has helped make the company hold back on everything from adding Web 2.0 features like video and social networking to spending $100,000 to translate its ebags.de site into German. "There are 10 of those things you just have to pass on," he says.

This year, many market observers expected the IPO market to stage a strong rebound (see BusinessWeek.com, 2/27/06, **"How the IPO Market Got Its Buzz Back"**). But it hasn't turned out that way. Instead, Wall Street has settled mostly for buying low-risk chip shots. Of the 121 U.S. IPOs done so far this year, about 25 were nontechnology companies that had been through leveraged buyouts. After trimming operations and restructuring the companies' finances, private equity funds brought familiar names like Burger King (**BKC**), J. Crew (**JCG**), and mattress maker Sealy (**ZZ**) to the public. Another 21 deals were for energy companies, says Paul Bard, an analyst at Renaissance Capital, an IPO research firm in Greenwich, Conn.

FALLING SHORT. Even when investment banks have floated tech deals, the results haven't always been pretty. The July blowup of Internet phone service provider Vonage (**VG**) got all the attention, but it was hardly the only one. April's deal for Visicu (**EICU**), whose hardware and software automate hospital intensive-care units and produce big savings in both cost and mortality, surged from a $16 IPO to $26. But its shares have since sagged all the way back to $7.50. Deals for e-commerce software provider Omniture (**OMTR**), online photo service Shutterfly (**SFLY**), and e-commerce order-processing company Synchronoss Technologies (**SNCR**) all priced below expectations. Even when the market made a rare bet on tech, it often bet on non-U.S. companies: The 37 startups on NVCA's list include Chinese medical-equipment firm Mindray Technologies (**MR**) and Korean e-commerce player Gmarket (**GMKT**).

Bard blames the market's current preference for larger companies, and the psychological impact of the odd junky deal like big money-loser Vonage. The odd thing is, the startups have actually performed better than the post-leveraged buyout and energy deals. Startup IPOs this year have posted an average 6.4% postoffering gain through Oct. 5, Bard says, beating the average 0.2% loss on leveraged-buyout IPOs and the 0.5% increase in the average energy deal. "Investors who do their homework will find opportunities," Bard says. "The quality and fundamentals have been superior to what's been offered in the past."

But investors' risk aversion is keeping companies out of the public market—and depriving them of cash they might have invested in new innovation. Morgenthaler says his firm has stakes in a handful of companies that would have been public by now in a prebubble market. Gauer points to Palomar-backed names such as business-process management firm Lombardi Software, telecom network-management software maker Continuous Computing, and Dorado Software, whose products let corporations tie together information technology from different vendors, as companies that are staying private because of the weak public markets. He says he's trying to keep the faith by assuming each venture investment will simply take longer to pay off.

As the Dow Jones industrial average's new peaks suggest, the market is ready to move beyond the bubble—for some kinds of companies. But investors are still nursing the wounds of the bubble's collapse when it comes to making bets on the very kinds of companies and risk-taking innovation that led to all that optimism in the first place.

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