RED HERRING THE BUSINESS OF TECHNOLOGY

Little Hope for IPOs in 2006

U.S. startups may turn to overseas markets next year, says venture group.
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As the U.S. initial public offering market continues to underperform, venture-backed companies in the United States may start looking to overseas exchanges next year when it's time to go public, predicts the National Venture Capital Association.

"Companies will continue to rely on the acquisitions market as an easier, safer exit strategy but will also search for more innovative opportunities," said the association Monday in its forecast of venture capital trends for 2006. "More companies will consider going public on foreign exchanges or soliciting offers from private equity firms."

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Out of the 10 largest venture-backed IPOs this year, only two involved companies selling shares on U.S. stock exchanges, research from *Red Herring* and Dow Jones' Venture One shows.

"Unless the SEC [U.S. Securities and Exchange Commission] figures out how the anti-growth and anti-jobs impact of SOX [Sarbanes-Oxley regulation] is on young growth companies considering an IPO, we will see U.S. venture-backed companies doing what until now has been unthinkable: going public on foreign stock exchanges like the Toronto Exchange or AIM, the small cap exchange affiliated with the London Stock Exchange," said Bob Pavey, a managing partner with Menlo Park, California-based Morgenthaler Ventures.

Reined-in returns
The U.S. IPO market isn't likely to recover enough next year to offer an attractive exit option for many venture-backed companies—a trend that's likely to rein in investment returns, said the association, which represents about 450 venture capital and private equity firms.

"The acquisitions market can produce respectable returns of four to 10 times investment but cannot alone support the level of cash distributions expected by limited partners," said the report, referring to the institutions that invest in venture capital funds. "Without these larger, IPO-driven distributions, the venture industry will not be in a position to achieve the above-market returns which limited partners have historically enjoyed."

Still, the NVCA expects venture capital fundraising and investment to increase modestly next year, rising by no more than 10 percent. That would mark the third increase in as many years, after fundraising plummeted from 2001 to 2003 (see VC Q3 Fundraising Up 16%).

“The number of venture firms may decline slightly as those unable to raise follow-on funds choose not to continue,” said the report. “This drop will be offset by veteran venture capitalists spinning out from existing firms to start their own emerging funds.”