

# Venture Capital Analyst

TRACKING INNOVATION AND THE MONEY BEHIND IT » JUNE 2005 | VOLUME IX | ISSUE 6

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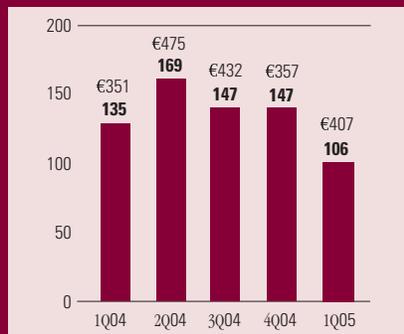
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## Fewer Deals, More Money

VCS backed fewer European IT companies in the first quarter than a year ago, but invested more as deal sizes grew.



Source: VentureOne/Ernst Young

## Start-Ups Struggle To Find A Place In Enterprise Software Market

BY JOHN W. VERITY

Is enterprise software dead?

Last year, acquisitions of public companies in the sector far outnumbered initial public offerings, by 19 to four. In a growing number of categories, software's being given away for free, leaving users to pay for support services - but only if they choose to. Developers are using the Web to provide software as a rental service, for monthly fees. Microsoft Corp., which just announced a new licensing venture for start-ups, seems determined to buy its way into the business. Information technology budgets are flat, with many corporations still trying to digest all of the systems they installed over the past decade to automate key business processes.

With all that, can there be any opportunity left for early-stage investors in business software? Or is this a field where only niche players merit financing and big exits are a thing of the past?

Questions like these are nagging many investors as the enterprise software market undergoes a radical transformation.

To be sure, underlying hardware and software architectures have

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## VCs Blame Sarbanes-Oxley Law For Delayed IPO Gratification

BY RUSS GARLAND

For venture-backed companies, getting ready to go public is harder than ever because of the Sarbanes-Oxley Act and the intense financial scrutiny it has engendered, slowing the flow of initial public offerings this year.

Only seven information technology companies registered for IPOs in the first quarter of this year, according to VentureOne, an industry tracker owned by Dow Jones & Co., publisher of this newsletter, down from the dozen that registered in the fourth quarter of 2004 when many start-ups were catching the tailwind of Google Inc.'s successful IPO last August. And the 16 IT companies that went public last year had gone a median of five and a half years since their initial venture financing compared with a median of about three years at the height of the technology boom in 1999.

With the flow likely to remain at a trickle, not a flood, venture capital-

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## SarbOx Slowing Tech IPOs

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ists probably won't see a robust exit market until 2006. In fact, many are telling their portfolio companies to hold off a year or more, including Timothy Draper, a managing director of **Draper Fisher Jurvetson**, who recently said Sarbanes-Oxley is "such a disaster that we've advised a lot of our companies to wait until they've gotten significantly bigger before going public." (*Venture Capital Analyst-Technology*, May 2005, page 18.)

Jeffrey Kuhn, co-founder and managing principal of Financial Leadership Group, a San Mateo, Calif., consulting firm that provides chief financial officers to technology companies, estimates SarbOx is adding at least another four to six months to the already time-consuming IPO registration process. Costs for a small company can range from \$250,000 to a \$1 million a year, he says.

That's certainly the case at **NexTag Inc.**, a six-year-old online consumer shopping service based in San Mateo, Calif. "Under the old ecology of public companies, we could have gone public last year," says Chief Financial Officer Steven Imbler, who has helped take two other companies through the IPO process.

### NexTag Still Preparing

NexTag says it already is past the \$100 million revenue mark and has been profitable for four years, but the company also is spending this year beefing up its corporate governance practice, upgrading its business processes and strengthening its management team to ensure that it will continue to perform well as a public company. NexTag also wants to expand its comparison-shopping business before management gets distracted by the worries of an IPO, Imbler says.

It can be very difficult and time-consuming for a small, closely-held company because under SarbOx the company must document consistent business practices and procedures and make sure they are in place, he adds. At a start-up with a small workforce, those practices are constantly changing as the company grows and so it is a challenge to complete the documentation the government requires.

Newly public companies have to be Sarbanes-Oxley compliant when they issue their first quarterly financial statement and it behooves them to prepare for this beforehand, depending on the complexity of the business. This can be a daunting expense for barely profitable venture-backed concerns. Furthermore, newly public companies face intense scrutiny from investors and their businesses better be able to

withstand it.

J. Sanford Miller, a senior partner at **3i Group PLC** and a former investment banker who co-founded **Thomas Weisel Partners LLC**, agrees. "It's a well intentioned law, but it's a mighty burden on a small, young, growing company," he says. "For smaller companies it is a big factor that will be sort of the last straw that breaks the camel's back in the ability to go public."

Axel Bichara, a senior partner at **Atlas Venture**, says it can easily take a venture-backed software company two or three years longer to go public than in the mid-1990s. One of his portfolio companies, **Spotfire Inc.**, a business analytics provider based in Somerville, Mass., founded in 1996, is still getting ready for an IPO despite annual revenue last year of \$30 million and a strong presence in the pharmaceutical industry.

Spotfire just hired an in-house lawyer and added a third independent director to its board, steps companies several years ago wouldn't have taken until they were public. It also is hiring a consultant to get the company Sarbanes-Oxley compliant. President Rock Gnatovich estimates that complying with the corporate governance law will cost Spotfire about \$1 million a year.

He declined to speculate on when the company might register for an IPO. "It really is a matter of the market and just preparing the company for the things we didn't really think about in the beginning," he says. Gnatovich estimates the company Spotfire now may need to hit revenue of \$50 million before it can file for an IPO. "I'm not sure it's not \$100 million," he says.

One company that recently surprised many who thought its IPO was imminent is **Vonage Holdings Corp.**, a four-year-old Internet telephony provider that recently closed another \$200 million round of venture capital, bringing its total raised to \$408 million.

### Living In 'Post-SarbOx World'

Vonage, says it will use the \$200 million from its fourth round, led by **Bain Capital LLC**, to speed expansion of its services in North America and the U.K. and to enter the market in Asia. While the company is not blaming Sarbanes-Oxley for keeping it out of the IPO queue, CFO John Rego says, "You must be truly ready to be a public company in the post-SarbOx world we're in."

It's significant that prior Vonage backers **Institutional Venture Partners**, **Meritech Capital Partners** and **3i**, are later-stage investors who typically would be looking to exit a company rather than make follow-on investments. 3i's Miller, who leads 3i's later-stage investments in the U.S. and represents

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the London-based firm on the Vonage board, says, “The opportunity has just been so good, it made sense to invest in expansion capital to fuel the growth of the business.”

While a public offering remains the Holy Grail for most venture investors because of the potential for higher return, the current IPO climate is forcing VCs to be more patient with their portfolios and to think even harder about whether an acquisition is a better exit. Certainly an attractive offer from an acquirer is hard to turn down. Even there, however, the cumulative impact of SarbOx is being felt. That’s because corporation acquirers must certify that the companies they buy comply with governance rules. Ensuring that a venture-backed company is SarbOx compliant “should do nothing but increase the value of the acquisition,” says Gary Little, a general partner with **Morgenthaler**, which owns 40

percent of NexTag. “It still benefits the company to build it as if it’s going to go public.”

“You really cannot run the venture portfolio with M&A in mind,” says Vladimir Jacimovic, a partner at **New Enterprise Associates**, a Vonage backer. “You always have to build those companies aiming to take them public.”

NEA is thinking that it might have to pump more capital into some of its IPO prospects so that they can acquire technology to flesh out their product lines. Otherwise, they risk getting beaten to the punch by their public competitors. But because absorbing other private companies is difficult and can be expensive, “we probably will play this pretty selectively and pretty carefully,” Jacimovic says. The strategy illustrates the advantage enjoyed by venture firms with deep pockets, such as NEA, which is deploying a \$1.1 billion fund.

**DOW JONES**

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