Venture Capital's New Adventure

Usual Role of Nurturing Start-Ups Takes On a Private-Equity Twist; Mr. Lanza Becomes a Deal Maker

By PUI-WING TAM
December 21, 2006; Page C1

The job of venture capitalists is changing. To understand how, consider Drew Lanza's summer: In addition to scouting for start-up companies to invest in, like most venture capitalists, Mr. Lanza suddenly found himself operating as a private-equity player and industry deal maker.

At the center of Mr. Lanza's activity was a small company called Cortina Systems Inc., a start-up chip maker in Sunnyvale, Calif., in which he invested $3.7 million in 2001. At the time, Mr. Lanza, a venture capitalist at Morgenthaler Ventures, of Menlo Park, Calif., believed the investment would follow the conventional venture-capital route -- that is, he would help nurture the company from its early stages until it was ready to go public and he could cash out.

Drew Lanza

But the market for initial public offerings of stock -- despite periods of life, including an end-of-year burst of deals this week -- hasn't returned to the level of activity of the boom period of the late 1990s and early 2000s, leading many venture capitalists to hang on longer to their investments. So while Cortina's business flourished, it remained a closely held company. This summer, in an effort to expand more quickly, Cortina entered discussions to buy Intel Corp.'s optical-networks components unit for $115 million in cash and stock.

That quickly vaulted Mr. Lanza into unfamiliar territory. To help Cortina buy the Intel unit and roll up, or acquire, other chip businesses, he raised $132 million from other venture-capital firms to fund the transaction.

He participated in acquisition talks with Intel, canceling a boating vacation in the process. After the deal was announced in September, Mr. Lanza got more than a dozen calls from other chip companies wondering if Cortina might be interested in buying them, too.

"I suddenly became aware that we were triggering a rollup in the sector and my phone was ringing off the hook," says Mr. Lanza, 50 years old. "It was very surreal. I'm used to wandering the halls of Stanford to fund companies founded by two guys and a dog."

Like Mr. Lanza, other venture capitalists have broadened their roles beyond investing in and nurturing start-up businesses. They more often find themselves handling spinouts -- or buying units of publicly traded companies -- as well as so-called rollups and buyouts, and generally engaging in more-complex financial transactions.

In other words, they have stepped into the realm of private equity, now one of the finance world's hottest arenas. The change could make investing in venture-capital funds more risky.

"The skill set to be the first money into a small tech company is very different than going into a bigger-money market where so many firms are all looking at the same large deals," says Peter Falvey, a managing director at boutique investment bank Revolution Partners in Boston. "Venture capitalists are really departing from their history of investing in small companies."

Though the IPO market has perked up a bit recently, it still isn't as easy to go public as is used to be. That is forcing venture firms to hold on to companies longer. The median time for a venture-backed business to go public is 6.2 years, up from 3.1 years in 1997, according to research firm VentureOne.

The shift also has been spurred by the excess cash that has flooded the venture-capital industry in recent years. The industry has raised more than $275 billion since 1999, and U.S. venture-capital funds raised $19.6 billion in the first nine months of this year alone, according to the research firm VentureOne. That means venture capitalists are responsible for putting increasingly large sums to work, which is difficult to do when investing only in start-up businesses. Start-up investments typically require several million dollars each, while buyouts, rollups and the like often require tens of millions of dollars a deal.

"Venture firms are now raising bigger funds and using the money to look at other growth opportunities like spinouts," says Rich Redelfs, a venture capitalist at Foundation Capital in Menlo Park. "They are becoming more private equity-ish."

While the venture-capital industry has dabbled in private equity-like activity before, the momentum has picked up. Venture-capital firm New Enterprise Associates, which has offices in Menlo Park, in July said it had raised a $2.5 billion fund and was earmarking more than a third of that money for larger, more-complex deals.

Other venture-capital firms that historically invested mostly in young companies, such as Draper Fisher Jurvetson, also have launched funds in the past year to do similar transactions. Last month, Austin, Texas, venture-capital firm Austin Ventures bought a majority stake in CreditCards.com Inc., a local Web site that aggregates credit-card offers so users can compare the deals, one of several buyouts it has completed in the past year.

Peter Barris, managing general partner at New Enterprise Associates, says the venture industry's move into bigger and more-complex deals is "a natural evolution." NEA began taking a concerted look at non-start-up investments when it closed a $2.2 billion fund several years ago, he notes.

Mr. Barris says these new types of investments are "no riskier" than a start-up investment, because they generally involve more-established companies with more-mature products and existing customers.

To minimize risk, many buyouts that venture capitalists are pursuing are smaller, in the tens of millions of dollars, than the multibillion-dollar deals of the big-name buyout firms. And most deals are structured with less debt, reducing a deal's complexity. Phil Siegel, a partner at Austin Ventures, says that while leveraged buyout firms often use $4 of debt for every dollar of cash in a deal, he generally uses $1 of debt for every $1 of cash in a buyout.

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