

# SVB ANALYTICS RESEARCH SERIES

## Volume 2

This report is the second in a series of research papers designed to address what drives value in the unique world of private equity and venture capital. Our studies involve thousands of venture-backed technology and life science companies and data from multiple sources – some of which are survey-based and some from private sources, which we know to be extremely reliable.

Our data reveals that a significant proportion of late-stage technology companies continuing to be funded in 2007 were born during the bubble years 1999 through 2000.

### “HOPE SPRINGS ETERNAL” - ALEXANDER POPE, 1733

The explosion of late-stage technology funds in recent years had us wondering if venture capitalists have shifted along that elemental investor continuum that connects the extremes of fear and greed. Does the predominance of the ostensibly lower-risk late-stage funds imply a certain loss of intestinal fortitude or are there sound reasons for the change in strategy? In short, is the shift to late-stage a reflection of the market opportunity or market psychology?

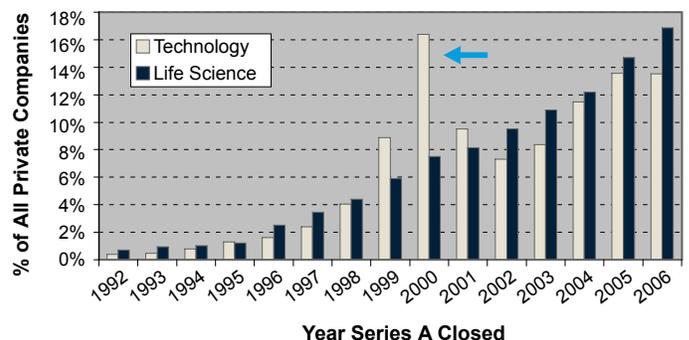
In the good old days a Series G would be wrapped in humble stories about a *restart*, but presented as “really a Series A.” Back then, dressing up a Series G in Series A clothing was the functional equivalent of putting lipstick on a pig. Eventually everyone usually figured out it was a pig. But then, as we all know, some pigs do fly. The late-stage vogue has spread far enough that we are now beginning to come across technology clients that are *unabashedly* Series G. There is of course no reason that a Series G is not perfectly palatable or perhaps even preferable to a Series A.

In our effort to better understand this later-stage movement and how it will affect valuations, we thought it would be useful to focus on the panorama of private technology companies that are the recipients of all of this late-stage enthusiasm.

### OPPORTUNITY ABOUNDS IN BUBBLE RESERVOIR

Courtesy of the investing hysteria at the end of the last decade, there appears to be no shortage of mature technology opportunities. Represented in Figure 1 are companies that have yet to exit as of January 2007, arranged by the year their Series A financing closed. Most notable is the spike in the center of the chart signaling a conspicuously high percentage of technology companies that closed their Series A back in 2000 and are still private and operating. Contrast this with the nearly text-book-perfect distribution of private life science companies (represented by the darker bars): the most recent year supplies the highest percentage of investments, and each successively earlier year offers fewer and fewer companies.

Figure 1: Private Companies by Industry (as of January 2007)



Sources: Dow Jones/VentureOne and SVB Analytics

Life science has such a smooth distribution because over time the companies in the industry have exhibited both a steady rate of exit and a steady trend in the volume of Series A fundings. While technology companies have also shown

a steady rate of exit, the industry saw an anomalously high number of Series A fundings in 2000, leaving a high inventory of private companies that the various avenues of exit have not yet absorbed.

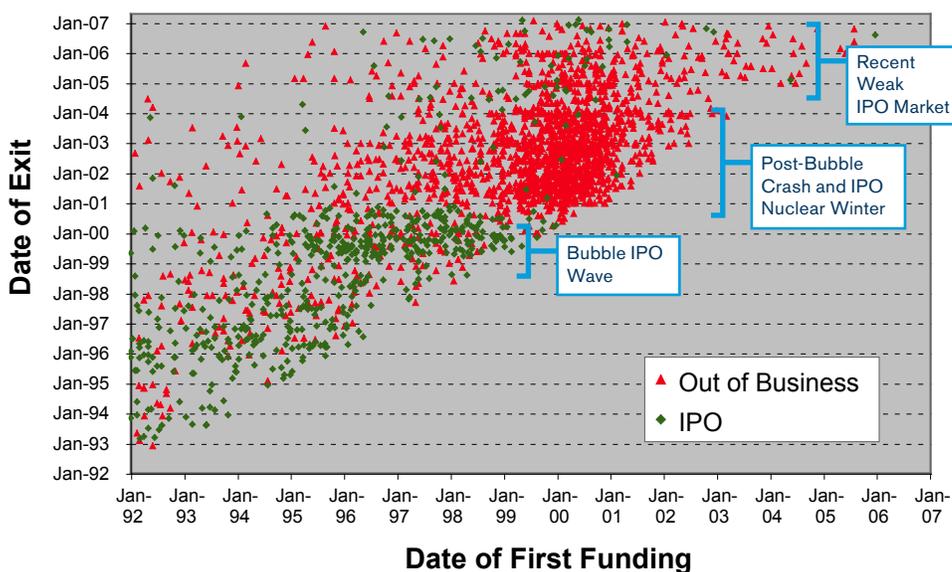
Of the profusion of technology companies first funded during 2000, one-third of those companies were acquired, one-third went out of business, a negligible few are public, and one-third are still private.

A common interpretation of this graph is that this abnormal surplus of private companies can likely be attributed to the bubble's "walking dead"— essentially companies that raised excess cash at fabulous valuations, idling away the months while management searches for a new business model. However, this is not the case.

### THE WALKING DEAD HAVE LEFT THE BUILDING

Our data reveals that over 70 percent of these bubble-era technology companies have received fresh funding in the last three years. Furthermore, they account for 25 percent of all technology rounds from the past 24 months. Surprisingly, not only are these companies still raising money successfully, but they are also playing a significant role in today's technology portfolios.

**Figure 2: Technology: Out-of-Business and IPO Exits**



Sources: Dow Jones/VentureOne and SVB Analytics

Even the remaining 30 percent of companies from 1999-2001 that haven't received recent funding are likely still considered viable by investors. Rather than sustain the dilution of another equity round, many of these companies are opting for debt to satisfy their capital needs. Their appetite for debt has been facilitated by the entrance of hedge funds into the venture debt arena. As loan terms have become less restrictive, often without covenants or liens, leverage has become an attractive and popular option that can mask declining valuation problems and lengthen the runway to a potential exit.

In other words, we believe the walking-dead constitute a negligible percent of these private bubble-era companies at best. In addition to the above evidence, our next figure supports this by illustrating that the rate of bubble-era technology companies closing their doors has subsided to pre-bubble levels.

### TECHNOLOGY EXIT TRENDS: THE NEW 'NORMAL'

Each dot in Figure 2 represents a technology company: red dots represent companies that went out of business, and green dots represent initial public offerings (IPOs). We can also see when the company first received funding, and when it exited. Notice the large, dense red cluster of companies in the center depicting the burst of the technology exuberance and the ensuing pandemonium of companies closing their doors. Note also that the vast majority of these firms received their first institutional funding during the height of that period.

Notice how, as our eyes travel up this red cluster toward present-day, the concentration of red companies begins to thin in 2004, and after January 2006 the going-out-of-business exits are back down to pre-bubble levels.

While the pace of technology company failures is stabilizing, the IPO market continues to struggle. In the same figure (Figure 2) we also see a bird's-eye view of the IPO landscape. Most obvious is the 1998-2000 IPO frenzy illustrated by the dense horizontal cluster of green dots. Even more notable is the dearth of IPO-green after January 2001, graphically displaying the desolation of the post-bubble IPO nuclear winter. Although

public equity markets are now more receptive (as evidenced by hot issues such as VMware) than the three years of bad harvests beginning in 2001, it is clear that IPO activity remains severely stunted.

### THE ALTERNATIVE EXIT

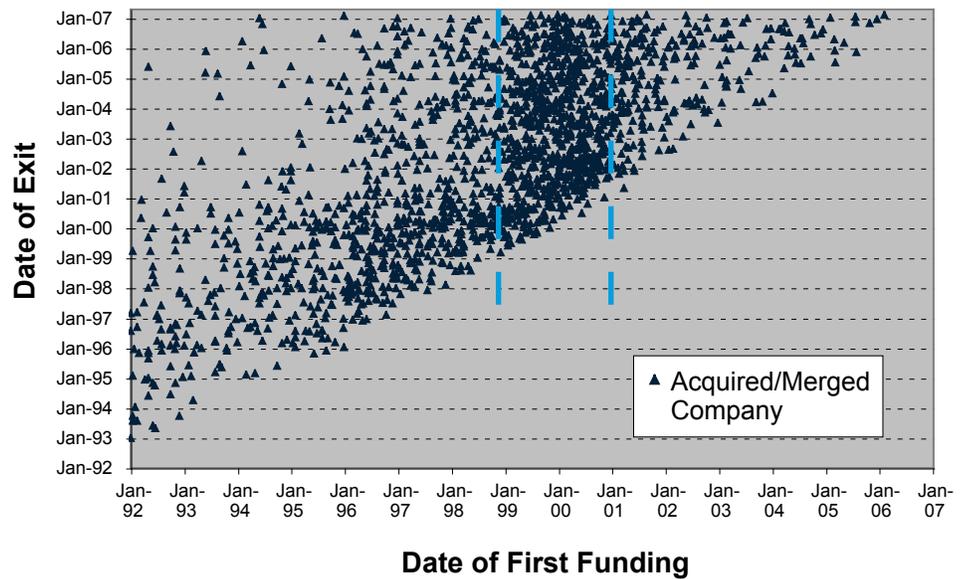
In contrast to IPOs, exits via mergers and acquisitions (M&As) have been, and remain, plentiful and steady. Figure 3 is similar to Figure 2, except here the manner of exit is a sale or merger. Notice the dense blue column of dots over the years 1999-2000, denoting the high volume of M&A exits for technology companies first funded during that time. Unlike receding out-of-business exits and sparse IPOs, mergers and sale exits continue to be consistent and, importantly, dominated by bubble-era companies.

### SO WHAT HAVE YOU DONE FOR ME LATELY?

It would seem that companies born in the bubble era have become sanctioned—and significant—recipients in the flush world of late-stage investing. They will, on average, comprise approximately one quarter of any late-stage venture capital portfolio. In number, they overshadow all others in the primary avenue of exit, M&A. The dust has settled on their going-out-of-business exits, and the walking dead no longer exist.

The elephant standing in the room of this late stage popularity, of course, is sunk cost theory. Sunk costs are costs that have already been incurred and cannot be reversed, such as investments in companies at inflated valuations. According to this theory, the rational investor should ignore sunk costs when making investment decisions, and instead make those decisions on merit alone. Underlying the obediently smooth slope of the life science bars (Figure 1), sunk cost theory is almost impossible to ignore in the pass/fail world of clinical trials and FDA approval — making it difficult to be adventurous with late-stage life science capital.

Figure 3: Technology: M&A Exits



Sources: Dow Jones/VentureOne and SVB Analytics

Conversely, in software there are always ready arguments to tempt the investor to ignore this theory: the product is close, the next big customer is just around the corner, the space is on the verge of exploding. Given this temptation, along with the spike of bubble companies still receiving funding, and our recent investigations into step-up values suggesting that volatility is high (see Volume 1 of this series), the premise of late-stage investing comes into question: Is it really less risky? What have returns been like for these investors?

Cisco’s recent agreement to buy Navini Networks comes to mind. A typical bubble company, Navini raised its Series A in 2000 and has since raised *nine additional* rounds for a total of approximately \$195 million<sup>1</sup>. Cisco will acquire the company for \$330 million, but is providing less than handsome returns to investors.

In Q2 2007, almost half of mergers and acquisitions with disclosed values produced total consideration for the sellers *less than* the total venture investment<sup>2</sup>. Analyzing how many sale transactions have been profitable to investors and how many were fire sales will give some insight to the potential success of the late-stage trend. We have added that to our research list. The results will go a long way in revealing whether the bubble-era yielded ideas worthy of such prolific and prolonged venture capital sponsorship, or if it is simply another example of Alexander Pope’s ancient observation that “hope springs eternal.”

<sup>1</sup> Source: PE Week, October 29, 2007 Vol.14, No.42

<sup>2</sup> Source: July 2 2007 Exit Poll Report by Thomson Financial and the National Venture Capital Association (NVCA)

## AUTHOR

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Cindy Moore joined SVB Analytics as a research director in 2007. She brings more than ten years' experience in mathematical modeling and statistical analysis. Moore has worked for Andersen Consulting (Accenture) and the Federal Reserve Bank, as well as software start-ups in the affinity recommendation, price optimization and supply chain collaboration sectors. She holds a bachelor's degree in theoretical mathematics from the University of California at Davis and a master's degree in theoretical mathematics from the University of Oregon.

**ABOUT SVB ANALYTICS.** SVB Analytics offers valuation and corporate equity administration services to SVB Financial Group's core constituencies of private, venture capital-backed companies and venture capital firms. SVB Analytics' services offerings include fair market IRC409A/FAS123R valuations and corporate equity tracking and administrative services. SVB Analytics is a member of global financial services firm SVB Financial Group, with SVB Silicon Valley Bank, SVB Capital, SVB Global and SVB Private Client Services, which serve the unique needs of technology, life sciences and private equity firms. More information on the company can be found at [www.svb.com](http://www.svb.com).

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Jim Anderson is president of SVB Analytics. Anderson joined SVB Silicon Valley Bank in 1999 and has served in a variety of capacities most recently as a founder, president and chief investment officer of SVB Asset Management and founder of SVB Securities. These groups hold total client assets in excess of \$15 billion.

He is the editor of the weekly *Investment Strategy Outlook*, published by SVB Asset Management and is a frequent speaker on the economy and financial issues affecting the technology and life science sectors.

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