



As good as it gets?

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Having just celebrated its fifth year as a public company, **Google Inc.** has managed in half a decade to mushroom from an initial public offering valuation of \$27 billion to a recent market capitalization of \$140 billion. Over this time, the company's ubiquitous Internet search technology has become popular enough to become a verb, and it has managed to crush competition from stalwarts such as **Microsoft Corp.** and **Yahoo! Inc.** The question often arises: Who will become the next Google?

If conditions persist as they have been throughout this Silicon Valley downturn, the answer might just be, "No one."

Inhabitants of this California technology corridor, stretching from San Jose north through the cities of Santa Clara, Sunnyvale, Mountain View and Palo Alto up the San Francisco Bay peninsula, are familiar with boom and bust cycles. The latest downturn has been tangibly tough here, with office vacancy levels in some Valley cities in the 50% range and unemployment in the area hitting a record high of 11.9% in June. But although the technology industry will recover, as it has in several downturns before, and the innovation engine that turns here isn't likely to idle, bankers, venture capitalists, entrepreneurs and other observers are uneasy, worried that the recovery this time around will bring with it a different reality, with significantly fewer VC firms providing less funding for a shrinking pool of new companies. It could upset the technology finance food chain -- the startup, the VC firm, the M&A adviser, the IPO underwriter -- in an unprecedented way, and make the establishment of a home-run, game-changing new company like Google a thing of the past.

"The winds have been taken out of the sails here, and no one's sure what is going to bring it back," says Jevan Anderson, a managing director of technology investment banking at **RBC Capital Markets** in San Francisco. "Each time this happens, things bounce back a little less than last time."

There is reason for worry. Exits for venture capitalists have been scraping bottom for most of this year. During the first half of 2009, only six venture-backed companies went public. M&A stats are equally dismal: The value of tech deals announced during the first half of 2009 was roughly \$58 billion, the lowest level for that period in five years.

Partly because of this lack of returns from their investment portfolios, prominent venture capitalists have been predicting a shakeout among their ranks. **Benchmark Capital's** Bill Gurley, for instance, last month argued that the VC industry could be decimated as institutional backers, stung by losses, become far more conservative. It won't happen overnight because of the long time it takes to unwind portfolios, but over the next half decade, a significant number of VCs could give up the ghost. "It shouldn't be surprising for the VC industry to get cut in half," Gurley wrote in a blog.

But the question facing the tech industry and the dealmakers that cater to it could be more fundamental: What if there are no more -- or at least far fewer -- opportunities to make major technological leaps that revolutionize the way enterprises manage their data, or how people watch television, or search for information on the Internet?

Naturally, arguments run on both sides of this issue. There is no way to predict where a breakthrough will occur, but some are confident that major advances are still possible -- and fundable, and capable of providing big investment returns -- in a variety of disciplines.

Flybridge Capital Partners' Jeff Bussgang argues that the concern of a dearth of tech discoveries might be a result of a parochial Silicon Valley perspective on what constitutes a technological breakthrough.

"Media and advertising is going through a big upheaval, but big change and innovation isn't just happening on the Internet," says the Boston-based VC. Bussgang predicts groundbreaking advances in human genome mapping, healthcare, energy technology, material sciences and miniaturization that could provide big payoffs for private investors.

"When I walk the halls of MIT, I see more innovation than I've seen in the past 10 years," he says.

It's true that there will always be pockets of innovation. And it's important to remember how easy it is to generalize about "information technology," when in fact hundreds of separate industries are nestled within that definition, with their own characteristics and maturities. But an argument **Oracle Corp.** CEO Larry Ellison made famous seems to have gained a particular resonance now. Back in 2002, Ellison argued that the IT industry has matured to become the domain of a handful of large, diversified companies that can offer broad and rich product portfolios and can survive the downturns that regularly hit the tech industry. He singled out software vendors **Ariba Inc.**, **I2 Technologies Inc.**, Commerce One Inc. and Siebel Systems Inc. as companies that could not survive. He has been half right, so far, about those companies: Ariba and I2 struggle on; Commerce One went bankrupt in 2005, and Oracle acquired Siebel for \$5.9 billion in 2006.

INDEED Ellison was doing his part to act on his belief in a mature industry: He made several other major acquisitions in the enterprise software industry, including the \$10.3 billion purchase of PeopleSoft Inc. in 2005, the \$3.3 billion acquisition of Hyperion Solutions Corp. in 2007 and the \$8.35 billion takeover of BEA Systems Inc. in early 2008. It is now swallowing up another Silicon Valley legend, **Sun Microsystems Inc.**

"These big guys aren't as focused on innovation as they are on consolidation," says Chris Lochhead, formerly chief marketing officer for Mercury Interactive, an enterprise software developer that **Hewlett-Packard Co.** acquired for \$4.5 billion in 2006. "There isn't any R&D anymore, it's just 'D' at the big companies. And if the big guys aren't doing research, where is the new mouse going to come from?"

The obvious answer to that question has traditionally been the well-funded technology startup. But with the potential shakeout in the venture industry, the solution isn't necessarily as apparent, argues Lochhead, who is now an adviser to several technology companies including HP, and contributes regularly on tech issues to various publications.

"The firms up on Sand Hill Road aren't really interested in taking the kinds of risks they were taking 10 to 15 years ago," he says.

A critical missing piece of the puzzle is the early-stage investment that gets new ideas off the ground, says Igal Ladabaum, who in 1998 cofounded Sensant Corp., a small maker of ultrasound equipment technology. Although the company, which he eventually sold to **Siemens AG**, wasn't part of the dot-com fervor, it derived an indirect benefit from the boom of the late 1990s.

"We ended up benefiting from the massive wealth creation that came from the dot-com boom, and got some early-stage funding from some very wealthy angels," says Ladabaum, vice president of R&D at high-tech hearing aid maker **InSound Medical Inc.** He says many of those investors are tapped out today.

"Now the real difficulty is: Who is taking the early-stage risk?" he says. "Why would you want to be an early-stage investor at this time?"

Were the IPO market more vibrant, InSound would have the potential to become a standalone company, Ladabaum contends. While it competes with large incumbents, its product is the only hearing aid completely invisible, sitting deep inside the ear canal. With the difficulty of getting the big funding necessary to build a nationwide distribution network for its product, InSound's future will most likely be inside a larger company.

"It is very difficult in this environment to build the type of company that is self-sustaining and built to last," says Tom Taulli, founder of research site IPOprofiles.com. "It takes a long time, and VCs and their investors just don't have the patience for that. Except for a handful of the top firms, VCs have gone so long without traction that it's getting harder to justify their existence."

Another key part of the tech deal ecosystem is suffering as well. The conventional wisdom was that the dead IPO market and many private investors cutting back on funding would spell a bonanza for small advisory firms that could shepherd companies to acquisitions by bigger technology players. VCs were sure to become much more active in researching all options available for their portfolio companies.

It hasn't worked out that way, for many reasons. Middle-market and even large bulge-bracket firms have been targeting the smaller deals that are the bread and butter of boutiques. But with the unprecedented turmoil among big banks, some bankers worry that this phenomenon could become permanent instead of cyclical. VC-backed companies -- the primary client of small advisories -- have not wanted to sell out at the low prices that bargain-minded buyers are seeking. Another contributing factor is the dwindling population of buyers, with Sun getting gobbled by Oracle and storage giant **EMC Corp.** buying Data Domain Inc., for example.

Add venture capitalists remaining hesitant with their money, thereby squeezing off the fundraising advisory business for boutiques, and it's pretty clear navigating through this downturn was a lot harder than many of these small advisory shops thought it would be.

For small Silicon Valley advisory firms, like **GrowthPoint Technology Partners LLC**, the past six months have been challenging at best. In February, managing director Michael Shepherd predicted as many as a dozen mandates for the Palo Alto tech advisory firm, which grew largely out of the former SVB Alliant.

Last year GrowthPoint sealed eight transactions. But the firm has notched just one to date this year: the sale of cloud computing startup Q-layer NV to Sun Microsystems in January for undisclosed terms.

"We take emerging technology and sell it to companies for large premiums," Shepherd says. "We rarely if ever do fire sales. You can do that to keep the tombstones coming, but we haven't."

One can't really direct the blame for the problems facing young technology companies and their backers and advisers on one particular factor, but some in venture capital argue that the structure of the banking industry, as it relates to taking companies public, is a major culprit.

The National Venture Capital Association has picked up that drumbeat in its efforts to find a solution for the unprecedented lack of investment liquidity its VC members face. The group's chairman, **DCM** co-founder and general partner Dixon Doll, has bemoaned that venture-backed companies that go public have very little support for their shares once they hit the market.

Mark Perry, a general partner for blue-chip venture firm **New Enterprise Associates**, agrees. While venture funding has undoubtedly become harder to come by, innovation is still moving along at full tilt in Silicon Valley. Perry, an early investor in successful companies such as digital TV recording service provider **TiVo Inc.**, argues that the banking industry is in no state to take VC-backed companies public in a sustainable way.

The so-called Four Horsemen -- Hambrecht & Quist Group Inc., Montgomery Securities Inc., Robertson, Stephens & Co. and Alex. Brown & Sons -- used to fill this need, but bigger institutions bought and eventually shuttered or dismantled these tech-focused banks.

"The engine that was built in the 1990s to take these investments public, properly review them, tee them up, do due diligence, write registration statements, do research for the investor so he could understand the investment, has been completely dismantled," Perry says. "If that remains a weakness, there will be far fewer companies going public, and the problem will remain the ultimate monetization of these private investments."

The NVCA has begun reaching out to tech boutiques to "identify ways to better serve the needs of emerging growth companies," as the group put it when it announced recommendations to restore liquidity to the venture-backed company universe.

But the NVCA's campaign has left many bankers at tech shops scratching their heads. It is highly unlikely that a small advisory firm would have the wherewithal or motivation to replicate one of the tech boutiques that took so many companies public nearly a decade ago. Besides, at this point there just isn't any money to be made in doing so.

"If you saw VCs rewarding specialist firms and excluding the standard big firms, that would tell us there is a worthy reward for building an IPO business," says Cabot Brown, a partner at San Francisco tech boutique **Seven Hills Group LLC**. But that's not happening. Instead, large firms are slicing up very small fees on small IPOs in an unprecedented way.

Take the filing last month of network security tech company **Fortinet Inc.** to raise up to \$100 million in an IPO. Three big banks -- **Morgan Stanley**, **J.P. Morgan Securities Inc.** and **Deutsche Bank Securities Inc.** -- shared the joint book runner role on the offering, with five smaller banks signed on as co-managers.

"You have three guys who will swallow up something like 75% to 85% of the economics, how do the co-managers make money to pay for their research operations?" says RBC Capital Markets' Anderson. "It just can't work this way."

VC-backed companies such as Fortinet are attracted to the marquee names of large firms when signing up underwriters. Echoing Doll's argument, he says companies then find that the banks' analysts often don't pick up coverage of their stocks once they go public.

One can hardly count this as the sole reason for the problems that are plaguing the VC industry, tech startups and their bankers. But it's one of the frayed strands in the fabric of Silicon Valley investment, company-building, innovation and deal making.

"There will always be certain things about Silicon Valley that are very powerful: the universities, the legendary companies, the tech ecosystems," Taulli of IPOprofiles.com says. "But if you look back at the cycles of IPOs and innovation in Silicon Valley, it could be a decade before everything lines up in a way where things return to some kind of 'normal' and companies can be built to last."