



MARKET REVIEW: TECHNOLOGY PRIVATE EQUITY - 2004 MARKET TRENDS

Much has changed in the investment community over the past couple of years. In this report, ComputerWire talks to independent corporate finance advisory boutique, Go4Venture, a London, UK-based company with a special focus on financing and exit strategies, and gets its insights to the year ahead and likely market trends.

An Overview of the Industry

Jean-Michel Deligny, founder and managing director of Go4Venture, believes that the consensus view for 2004 is for a recovery across all major economies. Among the major industrialized countries, he believes the US is stealing the show (+4.5% GDP), thanks to the Fed's low interest rates and Bush's "liberal" attitude to budget deficits. Compared to the US, Europe is improving but only fractionally (+1.9%). Asia is however really leading the pack. That is where the action is (+10% growth for China in 2003 alone).

In terms of IT spending, the landscape is not as clear. It is obvious that companies have been holding off investment for too long and spending has to resume given most equipment's three-year amortization horizon. How strong this renewed investment spend will be is an open question. Forrester is expecting a 4% IT spend growth in North America alone, while SAP and Cisco are more optimistic, with guidance in the 10% or more range.

The Overall Market in 2004

The big excitement comes from the IPO and M&A markets, and public company performance in general. This gives VCs confidence that the cycle is now reversed and exit opportunities are within reach.

The M&A Sector

On the M&A front, Deligny believes that the market has recovered strongly. He predicts there will be more of a market for small deals, where large corporates fill product holes by purchasing innovative start-ups. This model is already well established in the US and will also become more prevalent in Europe with both indigenous and US buyers. The recent acquisition of the German company Cobion by US security leader ISS for 26m euros (\$33m) is a good example of this sort of deal. In a way, the IT sector is moving one step closer towards the model of the pharmaceutical industry, where large companies outsource their R&D to start-ups.

Stock Market

There was a net gain of 34% across all major bourses in 2003, mostly fueled in Deligny's view by pension fund managers trying to beat sector indices, rather than propelled by any sensible view of absolute value.

In the technology industry in particular, gains on Nasdaq in 2003 reached 55%, which leaves valuations well ahead of themselves. According to analysts, the overall P/E is roughly double the long-run average. This means the market has moved close to 1998 valuation levels.

IPO Market

This is further confirmed by the state of the IPO market, where companies with weak business models are again being offered to investors. In October 2003 in the UK for instance, a business called IP2IPO, whose sole assets were long-term partnerships with UK universities, was valued at 130m pounds (\$241.8m) on its market debut, despite a very uncertain economic model.

Deligny believes the queue of IPO candidates for the first half of 2004 will have its fair share of hyped companies. He also thinks investors will realize it during the course of the summer, and that the industry is facing the real possibility of a serious air pocket in the stock market during the second half of 2004.

Go4Venture is preparing itself and its clients for a much tougher second part of the year. Deligny says that as investment committees are influenced by the state of the stock market, he advises people to get their deals done in the first half of 2004, otherwise clients might have to wait until early 2005.

The State of the Investment Market

According to Deligny, there has to be a clear distinction between VC and late-stage deals.

Late-stage technology deals have been fueled in the last couple of years by poor valuations in public stock markets, making it worthwhile for private equity players to arbitrage between public and private market valuations. This has been a great period for private investment in public equity (Pipe) and public to private (P2P) transactions. Deligny believes the popularity of Pipe and P2P transactions has probably passed its peak as public valuations have gone up substantially. Later stage investors have to go back to their normal game, i.e. spin-offs from large corporates and roll-ups of companies in an existing sector, both notoriously time-consuming to make happen. If anything, Deligny expects a slowdown in this area of the market.

In the VC part of the market, things seem to be improving, but slowly. From Go4Venture's perspective, it does not anticipate any dramatic change compared to 2003.

Progress is held up by VCs trying to hold on to what they still perceive as a buyers' market where they can set the terms of the deals. Go4Venture is therefore continuing to tell its clients to get to a position where they do not need to get money from VCs, and then engage in a low-key dialogue with investors. The idea is that, as time goes by in 2004, a few of the VCs will increasingly feel under pressure to get deals done and will put term sheets out earlier than before to pre-empt a full competitive process, hence the benefit of getting an adviser involved, which obviously signals competition to a VC.

Investment Demand

In terms of demand, the number of companies seeking funding will probably not change dramatically, according to Deligny. What will change this year is that there will be a larger number of the 2000-2003 survivors trying to get back to the market. However, these companies have cut back so much to survive that many have lost momentum and are not very attractive to VCs.

Yet the backlog of survivors will create lots of noise in the market, in particular for new A-rounds, which will be competing with companies that are not much more expensive, but already have proven products, reference customers and revenues.

The supply of money is also getting better. 2001 was obviously the year when all VCs changed strategy and went through a clean-up of their portfolios. In 2002 they started looking at new investments, and 2003 was the year when they all tried to get deals done at outrageously low valuations. 2004 should be the beginning of the return to normality for VCs, but Go4Venture does not expect a healthy market until 2005.

As VCs raise new funds, with the first wave of completion in 2005, they will have to throw more money at the market. So expect a slow 2004, a great 2005, and a vintage 2006.

What Does This Mean for 2004?

Go4Venture believes that 2004 will be similar to 2003, perhaps slightly easier in the first half and tightening again in the second half. For the very top deals, things will go much better, so there should be a loosening of the purse strings. Eventually this will translate across the board, but the full effect will not be felt until 2005.

In 2003, the feedback Go4Venture was hearing from investors was “we want real companies, we want revenues.” The company is now hearing: “we want real companies, we want customer validation, obviously revenues are important.” So there is already a slight change of tune from investors. By the end of the year, Go4Venture expects VCs to be not nearly as obsessed with revenues as they are today, which bodes well for a return to early-stage deals by next year.

Except for those very best deals (typically assembled around a serial entrepreneur), it will still be tough going in 2004. Go4Venture is advising its clients to allow 9 months for a fund-raising, which is obviously a far cry from the 3 to 6 months of the good old days.

From a valuation standpoint, the market seems to slowly getting back to deals with “normal” valuations. For an A-round, it is still whatever the investor or the entrepreneur can get away with. For B- and C-rounds, the market is going back to safe, very conservative industry valuation metrics.

Go4Venture is starting to see a return of outlandish deals, including a January 2004 \$31.5m A-round investment for Alereon, a US UWB chipset provider. However, Go4Venture is not convinced there will be so many examples of deals like this in Europe during 2004.

Where Go4Venture believes it can make progress this year is on terms, particularly liquidation preferences. Many VCs have now understood that a 3x and more liquidation preference is not sustainable. They have also realized that a liquidation preference is not such a great tool, creating tension with and a disincentive for them management. It is also of no use in case of real failure, when there is nothing to share anyway. Finally a liquidation preference has to be renegotiated at each fund-raising event. It is difficult to rationally justify since it essentially gives VC shareholders the same protection as privileged creditors while retaining all the upside of equity.

Go4Venture believes 1x liquidation preferences will become the norm this year and there could be exceptional deals without such clauses. The rest of the VCs in the market will eventually follow as competition to get good deals start to re-emerge. Again the full effect is not expected to be felt until 2005.