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Cool IPO market chills venture capital returns

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By Joseph A. Giannone

SAN FRANCISCO (Reuters) - A lukewarm market for initial public offerings in recent years has cooled venture capital investment returns, and many experts say the chill will not let up any time soon.

Since the market's peak in 2000, when hundreds of speculative companies failed soon after going public, investors have been a tough audience for start-up companies that are typically floated by venture capital funds. In the first half of 2006, just 29 VC-backed companies went public, compared with 250 in 2000.

Meanwhile, some 45 companies delayed or canceled their IPOs this year, the most since 2001, generally citing a weak market.

"Ever since the bubble burst, the markets haven't been what they once were, said Timothy Pollock, a professor of management at Penn State University. "There have been little pockets of activity, but overall it's a lot more tame."

All that means VCs are blocked from selling investments to the public, or get a lower price. Most VC investors have suffered negative returns on funds raised in the late 1990s.

Since 2003, the market has averaged 15 new offerings of U.S. operating companies per month, said Jay Ritter, a Florida State University finance professor who tracks IPOs. That is about half the pace set in 2000, when more than 400 companies went public.

VCs also play a smaller role in the market, with their investments accounting for 40 percent of IPOs since 2001. That is down from 60 percent during the peak years of the late 1990s and 2000, when high-flying VCs reaped huge gains on early-stage investments and floated shares whose prices quickly multiplied.

But the bubble collapsed.

"The market continues to be skeptical about very young companies going public," Ritter said. "The track record of these start-ups has been poor, and investors were burned so badly from the bubble companies that went public at such an early stage."

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Market changes have also had a role in the slowdown. Start- up companies are less liquid, so big funds tend to avoid them. Wall Street brokers responded by cutting back trading and research.

"The Nasdaq (Stock Market) is in sorry shape. It has become inaccessible for start-ups," said Bob Grady, who leads private equity firm Carlyle Group's $3.1 billion VC practice.

Many small companies are also choosing buyouts instead of an IPO to avoid the cost of complying with the Sarbanes-Oxley Act of 2002, the U.S. law designed to improve corporate governance.

This roadblock to public markets has forced VCs to sell their portfolio companies to a buyer or hold investments longer. It is one of the factors fueling the willingness of entrepreneurs to be acquired as an alternative to an IPO.

Acquisitions in technology and telecommunications so far this year have surpassed the overall numbers and the amount spent for all of 2005, according to data published last week by market researcher 451 Group. Deals worth $363 billion have surpassed the $357 billion spent in all of 2005. The number of deals is up by one-third to 2,775 from 2,039, 451 Group says.

It now takes six years between an initial financing and IPO, "considerably longer" than four years ago, said Joe Muscat, global head of Ernst & Young's venture capital practice.

But with the stock market recovering since August and investors gaining more certainty about the direction of interest rates, some experts say the capacity for early-stage VCs to exit investments through IPOs or mergers is improving.

"You're really seeing a volume acceleration in terms of exits for VCs, and that should only spur further investments as they recycle capital into new opportunities," Muscat said.

Some sectors, such as renewable energy and biotech, have enjoyed strong demand from investors, despite the cooler market.

Meanwhile, VC funds are hiring and raising new funds -- perhaps the best evidence that investors expect market conditions and investment returns to improve.

Investment activity has steadily risen over the past year to about $20 billion a year, said Tracy Lefteroff, managing partner of PricewaterhouseCoopers' VC practice. If anything, VCs have been forced to make better investments.

"Investment by VCs is up slightly," he said. "It's a healthy and sustainable level of investment."

(Additional reporting by Megan Davies and Yung Kim in New York and Mathieu Robbins in London)

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