How VCs Are Coping With the Downturn

David Sterman

11/17/08 - 10:55 AM EST
Editor's note: This was originally published on RealMoney. *It is being republished as a bonus for* TheStreet.com *readers.*

You can almost see the IPO market crash into a wall. Bankers pulled off 22 deals in the first quarter of 2008, according to IPOhome.com. That figure fell to 14 in the second quarter and to just seven last quarter. Now, the lights have been turned out. There has not been a single major deal since August, and the freeze is likely to persist through at least the first half of 2009 as well.

That has left many to wonder how venture capitalists, or VCs, will cope. When they placed their bets in recent years, they were counting on an active IPO market to take their investments off their hands. Now, they are faced with the prospect of ponying up more dough just to keep these investments afloat. For any investments that are already operating at break-even and don't need more cash right now, their VC backers are highly grateful.

I had a chance to chat with a San Francisco-based industry veteran who advises companies on their business development strategies and who keeps a close eye on the action in the VC community.

So how do the VCs find exits for their holdings in this environment? You can forget about small start-ups linking up with each other. They often have redundant technology platforms and offer little in the way of synergies. More importantly, it is hard to find the right price to set a deal, and backers are loath to put in yet more money to give these combined entities enough cash to await an eventual opening in the IPO market.

Yet an industry watcher I spoke with says that the VCs have another appealing exit strategy, and you'll be hearing a lot more about it in coming months: strategic buyers. Distinct from "financial buyers" such as private equity that is just looking for a profit, strategic buyers can look at these small VC-backed start-ups as a way to pursue new growth opportunities.

Who are these strategic buyers? Think about any major tech firm with plenty of cash. At last count, **Google** (GOOG Quote - Cramer on GOOG - Stock Picks) had $12 billion in net cash, **Microsoft** (MSFT Quote - Cramer on MSFT - Stock Picks) had $23 billion, **Apple** (AAPL Quote - Cramer on AAPL - Stock Picks) had $25 billion, and **Cisco Systems** (CSCO Quote - Cramer on CSCO - Stock Picks) had $21 billion.

Strategic buying is already in the stated plans of **Oracle's** (ORCL Quote - Cramer on ORCL - Stock Picks) Larry Ellison, who has a far smaller $2 billion to play with when you back out his company's debt load. At an annual meeting with shareholders in October, he told investors that "acquisitions that we've been looking at for some time are less expensive for us."

Even smaller firms with, say, $1 billion in market value and $300 million in cash will look to get into the action.

Make no mistake, it's a buyer's market, and the VC backers are going hat in hand to potential buyers. And only businesses that represent meaningful opportunities will likely find interest. My VC contact suggests that you look out for deals that will help spur growth in new niches for existing tech players, offsetting what is likely to be a challenging year for organic growth in 2009.

Thus far, only Cisco and Oracle have aggressively trolled for new businesses. You can get a sense of the type of deals to watch by looking at Cisco's $120 million purchase of Pure Networks in July 2008. Cisco decided it wanted to play a larger role in the emerging market for networked home appliances. Rather than internally fund this initiative, Cisco acquired a turnkey platform on which to build this new niche.

lthough Cisco paid $120 million for Pure Networks, recent revaluations of many tech companies imply that the deal would have been done for well under $100 million today. And VCs, knowing that it is a buyer's market, will need to be careful not to try to play buyers off each other, as is often the case when the macro backdrop is more favorable.

Even as VCs look to stimulate interest among strategic buyers, they have another issue to solve: Many of the VC backers are pension funds and endowment funds. And these funds are now overexposed to the VC investments, because of a relative plunge in the value of other investments that have pushed stated VC holdings above mandated thresholds. That means pensions and endowments can no longer be counted on to provide fresh capital to VCs and may even look to withdraw some current investments.

The net takeaway: VCs would certainly like to see the major tech players relieve them of some of their major holdings and boost their cash positions.

Next, I will look at the emerging trends in the wireless space, how it may shape the IPO market when it reopens, and how Google intends to become a wireless giant.

First, I discussed how the current downturn has thrown a wrench into the venture capital/IPO cycle. Now, I am looking ahead to the themes that will dominate in the next wave of IPOs. To get a read on the future, you need only look at the actions of **Google** (GOOG Quote - Cramer on GOOG - Stock Picks) over the last few years.

More than a year ago, Google embarked on a high-profile effort to shake up the process of awarding wireless bandwidth in the valuable 700 MHz spectrum. Though its bid was unsuccessful, Google ultimately forced **Verizon** (VZ Quote - Cramer on VZ - Stock Picks) to overpay for a winning bid.

But that wasn't Google's true aim. Instead, by heavily lobbying the FCC, Google increased the heat on Verizon to open up its network.

In the last week, the wireless environment has opened up even further, as the FCC has ruled that "white space" -- the spectrum traditionally allocated by broadcasters between channels -- can also be used for wireless broadband use. The signal strength for white space is far stronger than Wi-Fi, and implies that you'll soon tap into networks well beyond your home or office floor -- and it might not cost a dime.

This is all great news for Google and a host of upstarts that hope to get a slice of the fast-rising mobile content business. For VCs that are backing business models based on mobile applications (including mobile digital advertising, a truly local business) and social-networking sites, these moves are a godsend.

Conversely, this could be real trouble for Verizon, **Time Warner** (TWX Quote - Cramer on TWX - Stock Picks), **Comcast** (CMCSA Quote - Cramer on CMCSA - Stock Picks) and others that have been able to charge \$30 to \$50 a month for broadband access.

In this context, you can start to envision Google's grand plans for Android, and feel the excitement of any VCs that bet on disruptive opportunities created by an open wireless environment. The huge popularity of **Apple's** (AAPL Quote - Cramer on AAPL - Stock Picks) iPhone also instills confidence that the stars may once again be in alignment for tech -- once we get past this downturn.

Not only have consumers embraced the iPhone, but every major device manufacturer is looking to up the ante. Prediction: Smartphones on the market in early 2010 will make the current iPhone seem dowdy by comparison. And as these devices emerge, packed with processing power, ultra-sharp and larger viewing screens, and an ability to access this open bandwidth, a new era will likely emerge. Whereas the majority of email, social applications (Facebook, MySpace, etc.), various contact lists and collaborative shared applications are currently used in a PC environment, these smartphones will soon emerge as the dominant computing platform. PCs won't disappear, but they will no longer be the dominant computing platform.

And Google's Android, which currently looks like just a stab at another growth vertical, will turn into *the* growth driver, for which the company's current search business is just one component. In that light, it's easy to see why **Motorola** (MOT Quote - Cramer on MOT - Stock Picks) trashed its whole development effort and is now making one big bet on Android.

In a recent chat with an acquaintance who has hooks into the zeitgeist of the VC world, he noted that a few ancillary trends have emerged that will shape this smartphone experience. First, companies will need to build truly mobile-based Web sites, and not simply tweak their existing Web-based sites.

In addition, the steady proliferation of personal lists, from Facebook friends, Outlook contacts, IM monikers, etc., will all need to reside on one interface. Platforms that pull all this together could be a home run for start-ups focused in this area, if **Microsoft** (MSFT Quote - Cramer on MSFT - Stock Picks) or Google don't get there first.

To be sure, most companies in this space have yet to file for an IPO, so it's hard to handicap eventual winners in the public sphere. And some of the start-ups in this area will be acquired by rivals or run out of money before the IPO market reopens.

But you have to like Google's positioning in the context of these trends. If Microsoft, Apple or other public tech giants want to blunt Google's expected momentum, they may need to start to roll up some of these smaller companies.

This was originally published on RealMoney *in two parts (Nov. 13 and 14, 2008). For more information about subscribing to* RealMoney, *please click here.*