- THE WALL STREET JOURNAL.
  WSJ.com

- MARCH 13, 2009

Venture Capitalists Chart a New Course

By PUI-WING TAM

With their core business in shambles, some venture capitalists are changing their stripes, styling themselves as investors in distressed assets and public companies.

Since last year's market meltdown, venture-capital firms such as Venrock and Sanderling Ventures have ramped up their investments in public firms, typically through private stock placements known as "registered directs" and "private investments in public equities," or PIPEs.

Other venture-capital firms such as CMEA Capital are dabbling in distressed assets. In one situation, CMEA purchased one of its portfolio companies from creditors and sold off its businesses and intellectual property to help minimize its losses.

These moves are extreme measures in trying times. Most venture-capital firms have little to no experience investing in distressed companies or public firms. And the work of dismantling a company is far different than what venture capitalists are hired to do: Nurture companies to life.

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XenoPort

Venture capitalists have been widening their mandate amid the crisis. One firm,Venrock, took part in a 'registered direct' of biotech firm XenoPort.

The change is raising some alarm. "We never want to see our managers stray too far from their core competency," said Brandon Park, a senior vice president at PCG Asset Management, which invests in venture-capital funds on behalf of pension funds and other institutions. "Traditional venture capitalists work with young private companies and they should stick to that niche."

Mr. Park adds that many venture funds have charters that allow a certain percentage of assets -- typically 10% to 15% -- to be invested in assets other than private start-ups, which he said his firm carefully monitors.

Venture capitalists have little choice but to get more creative. Start-ups today take a median 6.6 years to go public or get sold, up from 5.4 years in 2005, according to research firm VentureSource. Through the first nine months of 2008, venture funds lost 4.3%, according to Cambridge Associates. Those figures don't take into account the severe decline in asset values since mid-September.

"Would we have normally done this? No," said Faysal Sohail, a managing director at CMEA who recently completed his firm's first-ever distressed investment. "But in a truly distressed environment, we have to figure out how to make money from it."

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Mentor Graphics

Mentor Graphics staffers work on a product line purchased from Agility Design Solutions.

CMEA's distressed investment was in software company Agility Design Solutions Inc., made to seek quicker returns and to protect an existing investment. Mr. Sohail's firm had invested slightly more than $5 million in the Palo Alto, Calif., start-up since 2006, using money from a $300 million fund that CMEA launched that same year. Agility produced lower-than-expected revenue and by December couldn't repay the debt it had taken on. It soon fell into the hands of creditor Comerica Inc., Mr. Sohail said.

Mr. Sohail decided to step in, using less than $1 million to buy Agility's secured debt to take over and operate the company. His strategy was simple: Sell as many assets as possible and try to protect his initial stake.

CMEA sold one of Agility's two product lines in January to software firm Mentor Graphics Corp. for an undisclosed amount. That same month, CMEA auctioned off Agility's other product line, which a private firm purchased for several million dollars, Mr. Sohail said. Last month, CMEA also held an auction to sell Agility's patents. While the auction isn't yet complete, Mr. Sohail said there have been some bids, which could yield several million dollars.

Overall, CMEA expects only to break even on the total amount it has invested in Agility since 2006. Mr. Sohail said it has made a fast profit on its 60-day investment in Agility's secured debt. "If you take a smaller asset, clean it up and sell it, the return timeframe is much better," he said.

Changes have also come to venture-capital firm Venrock, which veered from 40 years of private investing last week to launch a $194 million fund to invest primarily in publicly traded health-care companies. Venrock has already made two investments from the fund, leading an $86.6 million private placement in Cadence Pharmaceuticals Inc. last month and participating in a $40 million "registered direct" in biopharmaceutical firm XenoPort Inc. in December

Venrock partner Bryan Roberts said the firm has selectively invested in public companies since 2003. It decided to concentrate on the area after the recent market tumult, as valuations of public companies plummeted more quickly than those of private firms. That made public companies less expensive. "It's the lowest-risk theory," he said.

Mr. Roberts said the new fund plans to hold public shares for the long term. So far, though, the fund's two investments have dropped in value. Venrock got XenoPort's stock at $21.17 and its warrants at $25.40, but the Santa Clara, Calif., company's stock closed at $18.74 on Thursday. Cadence Pharmaceuticals, for which Venrock got shares priced at $7.13 and warrants at $7.84, closed on Thursday at $6.20.

Venrock's Mr. Roberts acknowledged finding a good public investment can be "a needle in a haystack" but notes his firm has staff who have specialized in public investing. CMEA's Mr. Sohail said of the move into distressed assets: "We have a lot of operating expertise, so for us it's not drifting from our core expertise."

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Printed in The Wall Street Journal, page C1