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The Venture-Capital Yard Sale

Firms Take a Practical Approach By Targeting Tech-Bust Survivors, Hoping There Will Be a Rebound

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Venture capitalists are known as risk takers willing to gamble millions of dollars on untested entrepreneurs trying to create the next **Google** Inc.

These days, some of these investors look more like shoppers rummaging for sale items in the bargain bin.

As competition for early-stage technology deals heats up and deals get more expensive, some venture capitalists have become more practical. Mirroring a broader market shift toward "value" investing, they are searching for beaten-down companies that may be on the rebound, often by sorting through the detritus of the tech-stock bust and placing lower-risk bets on larger companies that survived the carnage.

"It's not five guys in a garage; it's 500 guys in a warehouse," says Rory O'Driscoll, a managing director at BA Venture Partners in Foster City, Calif., who has been studying such "survivor" deals.

Consider BlueArc Corp., an eight-year-old computer-storage company that has sucked up more than $200 million from venture capitalists. An early darling of the once-hot computer-storage market, BlueArc employed as many as 180 people during its heyday some five years ago. After the tech-stock meltdown, BlueArc had trouble snaring customers and meeting revenue targets, partly because big companies were reluctant to buy from a start-up they worried could go out of business.

Despite tough times and layoffs, BlueArc's core technology "didn't change at all during that period. We kept cranking," says President and Chief Executive Mike Gustafson.

With the help of new investors Crosslink Capital and Meritech Capital Partners, BlueArc restructured its finances and installed Mr. Gustafson as CEO last year. By last month the company was in good enough shape to attract money from Morgenthaler Ventures, a Menlo Park, Calif., firm that normally invests in early-stage companies. Morgenthaler, impressed that BlueArc had racked up big sales increases and added customers like Chevron Corp. and Time Warner Inc.'s Turner Studios, led a late-stage financing round of $29 million.

Venture-capital firms "tend to get excited about an idea, overfund it, and then when that idea underperforms ... they move on," says Gary Morgenthaler, a general partner at the firm. "That doesn't mean that nobody's going to win in [a particular] category. It just means there may be bargains available."

Mr. Morgenthaler declines to give details about his firm's financial commitment to BlueArc, but a person close to the company says the last funding round valued the company at about a third of the roughly $300 million at which it was valued at its peak.

There are no assurances start-ups like BlueArc will stage a successful initial public offering of stock, or sell themselves to acquirers for attractive prices, which is how venture investors make money. And most traditional venture investors, including Morgenthaler, are still searching for new start-ups that could bring them Google-like returns.

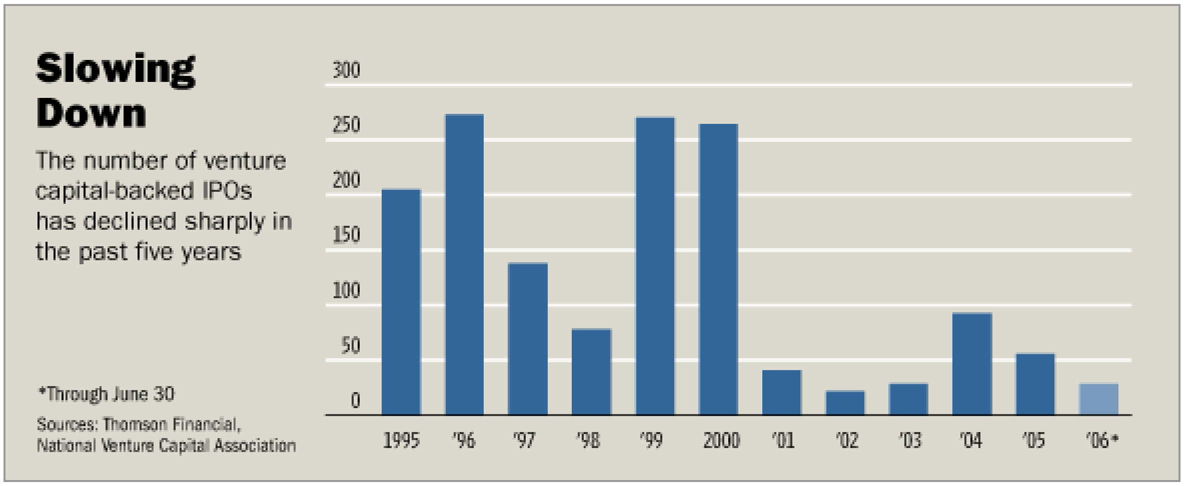
Still, the later-stage survivor companies are becoming more popular. That is partly because such firms are closer to staging possible IPOs and returning money to investors than tiny start-ups.

Waiting Is the Hardest Part

It takes more time these days for the average venture-backed company to go public -- about nine years -- compared with five or six years during the late 1990s, according to Thomson Financial and the National Venture Capital Association, a trade group.

What's more, unlike the current crop of hot start-ups in social networking or Internet video, many survivor companies sell software or networking equipment to big corporations and require more money to keep operating, says John Metz, an investment banker with Credit Suisse in Palo Alto, Calif. As a result, venture capitalists today have more opportunities to invest in these late-stage deals than in some of the more competitive Internet financings.

Another survivor of the tech-stock bust is network-equipment maker Force10 Networks Inc. Manuel Recary, an analyst with Kaufman Bros. Equity Research in New York, says it recently snagged big customers including Google and Yahoo Inc. and could go public in the next six to nine months. Kaufman has no investment-banking relationship with Force10.



Force10 attracted several value-seeking venture capitalists in 2004, when new investors Meritech, Morgenthaler and Crosslink contributed to a $75 million financing round for the San Jose, Calif., firm.

"There was six months of nail biting after we invested," says Crosslink partner Michael Stark. The company had burned through about $200 million in venture funding and "had a first-generation product that was getting pretty old." But business improved, and investors ponied up an additional $46 million for Force10 last year.

Omniture's Symphony

Another comeback firm is **Omniture** Inc., an Orem, Utah, company that sells software to help companies better evaluate the effectiveness of their Web sites. The company, which received funding from BA Venture Partners last year, launched a $70 million stock offering on the Nasdaq Stock Market in late June.

While Omniture's shares were priced below their expected range, they were up 7% from their $6.50 a share offering price yesterday. BA led a $40 million funding round last year and owned about 12% of the company before it went public.

Venture capitalists are even searching for gems in the wireless space: This year, Vesbridge Partners of Westboro, Mass., invested in eight-year-old mobile-phone software company FusionOne Inc., which hadn't raised money since 2000.

According to Ernst & Young, there were 882 U.S. venture-financed companies as of late 2005 that, like FusionOne, last raised money in 2000 or 2001. While some of those boom-era firms may yet flop, "I don't think all of those are simply going to wilt and go away," says Joseph A. Muscat, an Ernst & Young partner.

Of course, many of the good survivor investments have been snatched up at attractive prices. And many early-stage investors are still loath to get into late-stage companies because they often pay more for shares in these less-risky companies.

Passable Returns

Venture capitalists also sometimes accept lower ownership stakes, as many mature firms have a passel of existing investors. That means lower profits for the new investors when a company finally goes public or is sold. Plus, many investors simply "don't want to fix the mistakes of their competitors," says Crosslink's Mr. Stark.

But the likelihood of at least a passable return on a late-stage company looks attractive to many down-on-their-luck venture investors these days.

"Over the last five years, we haven't made a whole lot of capital gains for our customers," says BA's Mr. O'Driscoll. "So no one's going to sit there and get all virginal and say, 'I don't want to go late [stage] -- I don't want to make money.'"

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