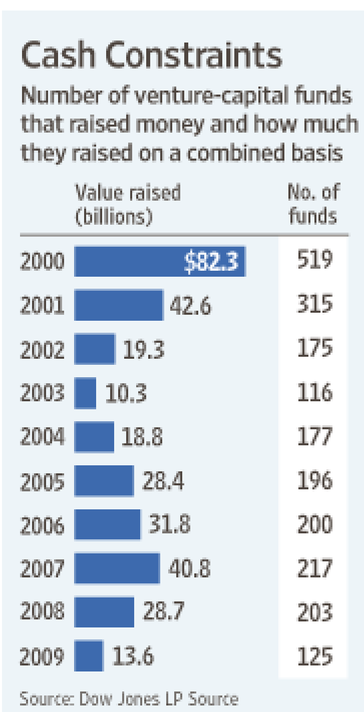
- THE WALL STREET JOURNAL.
  WSJ.com
- FEBRUARY 26, 2010

Venture Pools Begin to Show Some Fissures

By PUI-WING TAM

The thrill is gone for some venture-capital firms that pooled their money to invest in start-up companies. And that is causing difficult breakups.

As venture capitalists grapple with poor returns and a chronic shortage of incoming cash, a number of them are walking away from the investment syndicates they formed with other venture-capital firms, even though that usually means losing their entire stake in the start-up company financed by the group.



"Over the last year, we've seen an unprecedented level of syndicate failure," says Paul Holland, a general partner at Foundation Capital in Menlo Park, Calif. "We've seen at least 12 syndicates [in our portfolio] affected by this and never seen this amount before."

When a venture-capital syndicate collapses, the start-up companies and remaining venture-capital firms often must scramble for replacement funding to keep the companies going. Start-ups that can't scrape together more money typically go bust or are sold.

Last year, security-software firm Veracode Inc. was rattled when Polaris Venture Partners departed just as the company was working to complete a $10 million round of funding. The Waltham, Mass., venture-capital firm, which backed Veracode in 2006 with Atlas Venture, "walked out," says Matthew Moynahan, chief executive of the software company. "They didn't bet on us."

The CEO had to explain to employees and clients why an important investor had fled. "We were all quite shocked," adds Jeff Fagnan, a general partner at Atlas.

At least there was a happy ending: Atlas and venture-capital firm 406 Ventures filled the void left by Polaris. Mr. Moynahan says Veracode has increased its customers and revenue and is nearing completion of a new round of funding.

Terry McGuire, a Polaris co-founder and general partner, says Veracode "just wasn't a good fit for us at the time." The Polaris fund that sank money into Veracode is actively investing in other start-ups, he says.

The glue that holds syndicates together is giving way as many venture-capital firms run low on cash to invest. Some firms are near the end of the 10-year life span for their investment vehicles. At the same time, new infusions of money are scarce, with 120 venture funds raising a combined $13 billion last year, down sharply from the $28.7 billion collected by 204 funds in 2008, according to research firm VentureSource.

Of the 9,267 closely held companies in the U.S. backed by venture-capital firms, 59% have an investment syndicate. Such alliances, which aren't new, allow venture-capital firms to spread the risk of investing in a start-up, though some firms demand at least a 20% stake.

As the breakups mount, Mr. Holland points to a "barbell" effect in which stronger venture-capital firms often are able to keep investing in a start-up company even if a syndicate dissolves, while weaker firms can't.

Foundation Capital saw just such a split at Menlo Park-based software company Pano Logic Inc. When co-investor ComVentures morphed into a new venture-capital firm called Velocity Interactive Group, it pulled out of Pano Logic. Velocity later renamed itself Fuse Capital, which declined to comment. Mr. Holland says Foundation decided to stick with the company because it was "a younger company with unknown upside." On Wednesday, Pano Logic said it had raised a fresh $20 million in funding.

But another company backed by Foundation, networking concern Hammerhead Systems Inc., closed down last year partly because its investment syndicate fractured. Hammerhead had raised more than $100 million from venture-capital firms.

Co-investor Enterprise Partners is "exiting" the venture-capital industry, according to Mr. Holland, while the person at Mayfield Fund who led that firm's investment in Hammerhead left. Mayfield declined to comment, and Enterprise didn't return calls for comment.

Lisa Suennen, a co-founder and managing member of Psilos Group, says her venture-capital firm avoids syndicates in order to avoid such blowups. It can be impossible to navigate the competing agendas of a hodgepodge of firms, she says. For example, one venture-capital firm that is nearly out of cash could pressure a start-up firm to put itself up for sale, while stronger firms dig in their heels to keep the upstart independent.

"There's always the problem of disconnected interests," Ms. Suennen says.

Some venture-capital firms are trying to reduce their involvement in a syndicate without causing them to implode. One option is to sell all or some of the firm's stake to another firm or an outside buyer.

Last year, Scale Venture Partners of Foster City, Calif., invested in email-marketing software and services firm ExactTarget Inc. partly by buying an equity stake in the Indianapolis company from a venture-capital firm that wanted to sell out a chunk of its stake, says Kate Mitchell, a Scale co-founder and managing director.

"More of that's happening where folks are raising their hand to sell early," she says. "It's an orderly breaking of syndicates."

Write to Pui-Wing Tam at pui-wing.tam@wsj.com