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Venture Capital Still Loves the Net

VC firms doubled their investment in U.S. Web outfits in the first quarter, but a weak IPO market means they'll have to keep injecting cash

by Aaron Ricadela

Venture-capital investors poured record amounts into Internet startups in the first quarter as companies sought to raise cash ahead of a possible recession. But a weak start to the year for initial public offerings and acquisitions of these young companies may mean VCs will need to keep funneling cash their way for a while longer.

First-quarter investments in U.S. Internet companies more than doubled from a year ago, to $1.58 billion, across 170 deals, the highest numbers on record, according to Dow Jones VentureSource (NWS). The amount invested also was up nearly 50% compared with the fourth quarter of 2007. It was the first time that VentureSource's "information services" category, laden with so-called Web 2.0 startups, eclipsed traditional packaged software as the No. 1 information technology investment category.

The surge in deals, which ran counter to an overall decrease in first-quarter VC investments across all industries, suggests that Web startups may have been buttressing themselves against the economic downturn and the risk that funding might grow scarce if the credit crisis worsens. "Because of uncertainty in the public markets, they may need to get financing earlier to carry them," says Jessica Canning, VentureSource's global research director.

AN OPAQUE OUTLOOK

Indeed, the catch for VCs has been that the worsening economic and financial backdrop took a toll on buyouts and initial public offerings of stock in the first quarter, preventing them from cashing out of the maturing startups they've funded. Buyouts and IPOs both yielded the lowest quarterly payouts in years, and VCs aren't sure when matters will improve. "The outlook is opaque," says Laura Sachar, a general partner at StarVest Partners, the largest institutional shareholder in software company NetSuite (N), which went public in December (BusinessWeek.com, 12/20/07). The IPO market has proven tougher than VCs expected, though it could improve in the third quarter, she adds.

As a result, VCs are holding their stakes in startups longer then ever. In fact, later-stage financing rounds accounted for 39% of all first-quarter financing rounds, up from 32% in the first quarter of 2007. If the IPO and takeover markets remain tepid, it could force venture investors to shift even more funding to later-stage investments so they can keep the companies in their portfolios afloat longer. That in turn would affect everything from how many new startups VC firms can fund to the size of the payouts they'll seek to meet their targets for return on investment.

Overall, VCs invested $6.84 billion across all U.S. industries during the first quarter, down 7% from $7.35 billion a year ago, according to VentureSource. The dip in investments came largely because health-care investing dropped to its lowest level in two years.

SAFER BETS IN A WEAK ECONOMY

A separate study also released Apr. 19 by PricewaterhouseCoopers and the National Venture Capital Assn., based on data from Thomson Reuters (TRI), found U.S. venture investments slipped in the first quarter to $7.1 billion, down about 5% from a year ago. VCs made $1.3 billion in "Internet-specific" investments, the fourth quarter out of the last five when the category has garnered more than $1 billion, the study found.

Many VCs are looking to Web-oriented companies, which typically require smaller investments to operate than firms in other sectors, as safer bets in a weak economy. Battery Ventures made three first-quarter investments of less than $1 million in tech startups, including a data-analysis software maker named Lattice Engines and an undisclosed social media advertising company. "It gives you more shots on goal," says general partner Roger Lee. The small investments can let Battery own 30% or more of a company for a small amount. Even if a company is eventually sold for less than $100 million, "that kind of outcome is reasonable for the fund," he says. "We don't need to generate a $1 billion exit for it to be a good return for us."

Home-run IPOs and buyouts were hard to come by in the first three months of 2008. IPOs of U.S. venture-backed companies raised a median of $53.4 million, the lowest since the second quarter of 2006. And just 80 such startups were acquired, the lowest count since the beginning of 2003. Buyers paid less for them, too: a median of $63 million in the first quarter, vs. $90 million a year earlier, according to VentureSource.

It's also uncertain whether the big tech acquirers of 2007—Google (GOOG), Microsoft (MSFT), and Yahoo (YHOO)—will spend 2008 digesting those acquisitions or making more. "You could argue it both ways," says Battery's Lee.

Overall, the technology sector drew $3.88 billion in VC funding across 373 deals, up 20% from the $3.24 billion invested in the first quarter of 2007, VentureSource says. Among the largest venture deals was Slide, a maker of software widgets for social networks that raised $50 million in January (BusinessWeek.com, 1/18/08). And social networking site Facebook raised $40 million in March.

Those two deals will likely yield big returns for their investors. What's less certain are the returns from the hundreds of tech startups VCs are staking each quarter despite the murky outlook for big cash-outs.