Thoughts from the Field

Each month, this section of the CEUT Software Scorecard features an article or a Q&A session with a notable software company executive or investor who will provide his/her own take on the thoughts from our previous month's cover article (or on anything else that interests his/her). This month's guest is George Bischof, General Partner at Focus Ventures in Palo Alto, CA since 2000. Previously, George was a Software investment banker at Robertson Stephens.

Q. First, provide us with a brief background on you, your firm and its relationship with the IPO markets?

A. Jeff Becker knows my background all too well since he was my east coast counterpart at Robertson Stephens during the IPO boom days. My tenure at Robertson spanned from 1989 through early 2000 and I had the privilege of working with some great teams. It's nice to see several of these former clients, such as Siebel, BEA, JD Edwards, Epiphany, Broadvision, Portal and Concur, still trading above a $200 million market cap! I joined Focus Ventures, an expansion/later-stage venture capital firm focused on the software, communications and semiconductor sectors, in early 2000 and we have been fortunate to have our share of success in the IPO markets as well. In fact, 17 of the 33 companies in our 1997 fund have gone public and that fund was one of the top 10 performing venture capital funds of that vintage year.

Q. What do you think the reasons are for the dearth of IPOs in the tech/software sector in the past two years?

A. The recent demise is unprecedented. Overall IPO activity in Q1 of this year reached lows that had not been seen since the early '70s. I believe there are multiple demand and supply-related reasons behind the dramatic halt of IPO activity. If you start by looking at investor demand, public managers have seen assets under management dwindle as a result of capital losses and redemptions. With less dry powder, the investment community usually tends to become more risk averse and places a higher bar on 'new' investment candidates. Additionally, psychology plays a role. Investors remember getting burned by prior IPOs and small-cap public technology stocks and often move toward the perceived safety of bigger companies that have been around for a long time.

Though these are important factors, I believe the supply-side of the equation actually has had an even greater impact in stunting IPO activity. In many ways, the frothy IPO market of 1998-2000 pre-maturely graduated the potential IPO classes of 2001-2003. It takes time to rebuild the pipeline and in today's soft economy it will be challenging for more than a handful of companies to achieve critical mass with strong growth rates in the near-term. Even for the success stories, such as Google, going public is still a difficult decision. With the uncertainty of corporate IT spending and the volatility of the geopolitical environment, even companies that are performing extremely well rarely have the visibility on their own businesses to believe now is the right time to go public. If you are profitable, staying private is always a nice option until the climate changes. For those companies that are not yet profitable, later-stage venture capital can be an attractive option to help grow the business. Expansion-stage equity can provide similar amounts of capital as an IPO. In addition, given today's low public stock multiples, the relative cost of capital of another private round is not as expensive as it traditionally has been.

Q. You refer to a higher bar. Where is the 'IPO bar' in your eyes?

A. If you base it solely on the most recent IPOs and filings, the bar is extremely high. The critical mass of the majority of the 2002 IPOs was staggering versus historical metrics. For example, Seagate, Plumtree and Netflix had revenue run rates of $6 billion, $100 million and $120 million, respectively. The recent filings of Netgear and Crystal Decisions, each with revenue run rates in excess of $250 million and profitability, extended this trend into 2003. All of this does not startle me given the current environment. As mentioned earlier, risk-averse investors have a preference for the perceived safety of bigger companies. It makes sense that the first few companies out of the gate are larger entities that have been in business quite a while. In fact, Seagate, Crystal Decisions and Netgear are all spinouts of significant public entities. In addition, in terms of the supply part of the equation, companies with greater critical mass typically are more ready to go public. They are less likely to miss their quarter by losing one or two significant deals due to timing and they should have more visibility on their business since they have a larger installed base.

Consistent with Jeff's view in his "Those Were the Days" piece in the May edition, I think the current IPO bar is an anomaly and will revert to the historical metrics. We're not talking about 1998-2000 but rather pre-Bubble times. Back then you generally needed: $25+ million of trailing twelve months revenue, growth rates of a more rational 20+% and two quarters of profitability. This is good news! During the Bubble, companies were stretched so thin to meet the 100+% growth expectations that they could not support their customers. This was not a winning proposition for the long-term.

The key to the return to a more 'normal' IPO bar in my mind will be the economy. When Fortune 500 companies start to see improvements in their businesses and begin to feel healthy, IT budgets will return and technology vendors will start to experience greater growth and visibility in their businesses. All of this will help ease the supply constraints mentioned earlier. We hear from a number of public institutional funds that they will be ready to invest in a leading company in an interesting space that is profitable and growing from $25 million in revenues to $35 million. Who can blame them? That certainly beats the growth rates of the S&P 500 and there is greater earnings leverage in these companies as well.

Q. Since Focus Ventures is a later-stage firm, elaborate on the venture capital market for companies evaluating one last round until the IPO market returns.

A. The amount of venture investing has plummeted 80+% from 2000 levels and the number of expansion-stage investors has decreased as corporate strategic investors, mutual funds and investment banks have largely departed the late-stage investing market. At the same time, well positioned, growing expansion-stage companies should not be concerned because they are in relatively scarce supply. Just like the public market investors, there has been a flight to quality among the venture capital community. And there is still a lot of money out there. $75+ billion in venture capital overhang has yet to be invested. There also has been an increasing trend that more and more of the invested dollars these days are going to more mature companies. At Focus Ventures, we view the current environment as a unique opportunity to invest. The IPO bar over the past year or two has been so extreme that few companies can clear it. This is an ideal time for us to invest in more mature companies that are looking for some additional capital to strengthen the balance sheet. This cash cushion also comforts prospective customers and provides greater flexibility to make some acquisitions as well as provide some insurance. At Focus, we alone have approximately $200 million (excluding reserves) to invest over the next two years in these winning companies and others share our enthusiasm for this opportunity.

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CEUT at a Glance

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Open Source Software Symposium Recap

Our symposium, held on May 20th in Boston, turned out to be a terrific event, made even more topical by the recent legal tactics of SCO and the counters by Novell. The symposium was fully attended, we had 10 great panelists and informative and entertaining speakers.

Katherine Egbert, CEUT's senior infrastructure software research analyst, started the day out with a thorough overview of the origins and evolution of open source software, an analysis of the various types of open source licenses and their implications.

Bob Young, founder/former CEO of Red Hat and current CEO of Lulu.com, told the crowd that one of the keys to making customers of an open source software company happy is to empower them by giving them the control to make modifications and fixes to the software. He also shared that a key to ultimate success is to be sure you are adding more value to your customers than to your competitors by open sourcing your product.

The panelists on our two panels were very articulate and informative (and well behaved, too!). Some of the advice from the discussions was to:

- Provide considerable additional functionality and other benefits on top of the base open source platform
- Keep the open source community happy to be able to receive their innovations and refinements, while also increasing brand awareness and acceptance in the community
- Be careful to walk the fine line between what you need to do as a for-profit, commercial enterprise with the interests of the open source community, otherwise it can spawn off a new open source community.

We would like to thank the law firm of Testa, Hurwitz and Thibeault for their great hospitality in hosting the event and providing important insights into key legal considerations around building an open source-related business. And, of course, we want to thank our keynote speaker, Bob Young, and our executive panelists (from Bynari, Codeweavers, CollabNet, Polyserve, Progeny, Sendmail, Sistina, Sourcefire, Ximian and Zope).

Please keep on the lookout for future events from CEUT's Software Team.

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