

TECH BUY-OUT FUNDS AS A NATURAL EXIT FOR VC-BACKED COMPANIES

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Rainmakers
PRIVATE EQUITY

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1. EXECUTIVE SUMMARY

The number of IPOs has significantly decreased since the burst of the bubble, making acquisitions the most likely liquidity event for venture backed companies.

Venture funded companies from the 1999-2001 period who survived the bubble often generate a solid revenue stream and respectable earnings, yet they lack the attractiveness to be acquired by a strategic buyer, or they operate in a space with too few potential strategic buyers.

Such companies present a serious challenge to the venture capital funds that back them because the vehicles who invested in them are maturing, and they need an exit event for such companies in order to liquidate the fund and return capital to the limited partners.

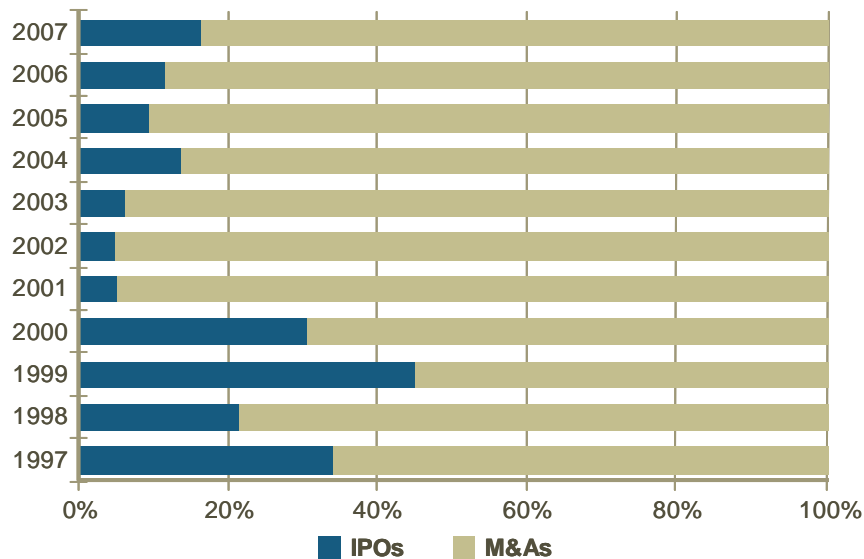
This paper will explain how in recent years, a new group of financial buyers has emerged as potential acquirers of such companies.

This category of buyers is still too new to have well defined boundaries, some call themselves Technology Buy-Out funds, others operate within their existing Late-Stage Venture funds, Growth Capital funds and some are transplants from the mid-market Buy-Out space. For consistency in this white paper, these transactions will be referred to as "Tech Buy-Outs" regardless of the buyer.

2. LIQUIDITY EVENTS FOR VENTURE-BACKED COMPANIES

According to data provided by VentureOne, since the burst of the bubble, IPO exits for venture-backed companies have decreased by as much as 78% between 1999 and 2006 in the United States. During this period, the number of IPOs decreased from 250 to 56, while the number of M&As increased from 307 to 421.

Figure 1 Percentage Breakdown of Venture Backed Liquidity Events: IPO vs. M&A



Source : Peac 2007

In Europe, the number of IPOs has picked up to 87 in 2006, after hitting a low of only 9 IPOs in 2003. M&A counted for 214 liquidity events in 2006. Both in the United States and in Europe, M&A remains the main liquidity event for venture-backed companies.

M&A exit opportunities tend to show a bias towards market trends, and a strong asymmetry in favor of companies with breakthrough technology and high growth potential. Companies such as YouTube or Skype offered a favorable exit opportunity to their investors, despite arguable business models and revenue streams. Paradoxically numerous companies operating in a less glamorous space, yet who have a proven business model and a solid revenue stream face difficulties in finding an acquirer.

3. THE NEGLECTED SPACE

From 1997 to 2000, 6,832 companies raised a first round of financing from venture capital firms in the United States¹. Many of the survivors don't have the growth momentum to be successful IPO candidates. In addition, they often operate in a segment that is not perceived by the market to be "the next big thing". Many have experienced roller-coaster valuations, or have been turned around after one or several management changes. So while many of the surviving companies currently generate a solid revenue stream and net earnings, they nevertheless struggle to find an acquirer. This difficulty is amplified if the company is operating in a vertical space with too few potential strategic buyers.

This group of companies represents the "Neglected Space".

As pre-bubble venture capital vehicles mature, GP's and CEOs face an increasing level of pressure to find a viable exit strategy. As numerous venture capital firms face the challenge of how to exit pre-bubble investments, there is a growing perception among a number of Private Equity groups that this Neglected Space is a fertile ground for remarkable investment opportunities.

Overall, the phenomenon is all too recent to have well-defined boundaries. For instance, some of these firms call themselves "Tech Buy-out" or "Venture Buy-out firms," while others are natural extensions of Growth Equity funds, Late-Stage Venture funds or Lower-Mid Market Buy-Out firms. Even a few hedge funds look into the segment for attractive opportunities.

4. THE CONVERGENCE POINT

The key understanding is that the profile of an attractive investment used to be fundamentally different between a venture capital firm, a buyout firm and a hedge fund; however this difference is beginning to blur.

For example, traditionally a buyout firm could not afford to finance a profitless semiconductor or biotechnology startup with debt, no matter how promising the technology might have been. At the same time, venture funds generally would not find mature, slow-growth retail and service businesses attractive the way buyout firms do. In fact Leveraged Buy-outs, where the acquisition is highly leveraged by debt, is still a relative rarity in the technology space, and concerns the higher end of the market. This is exemplified in transactions such as SunGard's acquisition by a club of private equity firms led by Silver Lake.

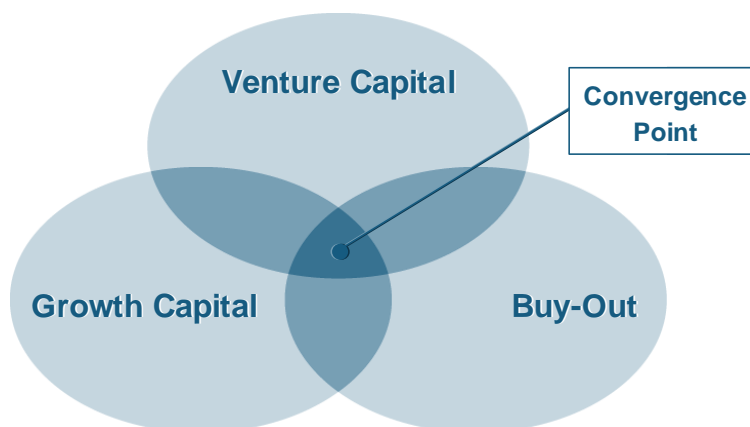
However this is beginning to change.

The amount of capital raised by hedge funds and buy-out groups, in recent years, has pushed these groups to look for opportunities beyond their primary focus. As a result, there is an increasing overlap of what is considered to be an attractive investment for Late Stage Venture Capital firms, Growth Capital funds, Buy-Outs groups and Hedge Funds.

¹ According to Dow Jones VentureOne

According to a survey published by the National Venture Capital Association on December 18th 2006², most Venture Capital firms in the United States expect to see increased competition from other alternative asset classes in 2007, with 62 percent saying the venture capital industry will more intensely compete with hedge funds for deals and 48 percent believing there will be more competition from buyout firms. The same survey finds that 71 percent of the venture capitalists surveyed believe the purchase of portfolio companies by private equity firms will become a more attractive option in 2007.

Figure 2



5. PURE-PLAY TECH BUY-OUT FUNDS

From 1999 to 2001, 1,110 venture capital funds were formed in the United States, with a total of \$191.2b in capital commitments³. Capital commitments fell to a low of \$12.4b within 140 funds in 2002 and to \$9.9b in 2003, before stabilizing at around \$25b in 2005 and 2006.

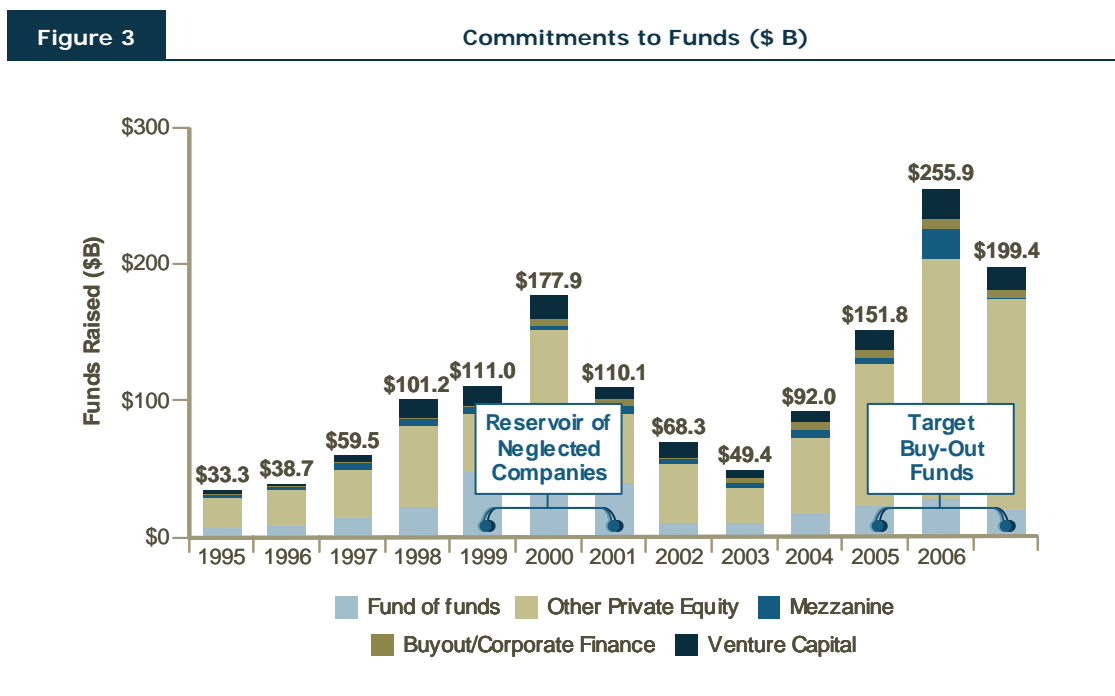
From the perspective of the limited partners, the returns generated by the venture capital asset class turned out to be highly asymmetric. A small group of players continued to generate outstanding returns, whereas most early stage venture capital firms had disappointing or negative returns. At the same time, thanks to unprecedented liquidity in credit markets, buy-out firms generated higher returns, with lower levels of risk, while allowing limited partners to deploy considerably larger amounts of capital. Limited partners turned away from early stage venture capital investing, in favor of other segments of the private equity asset class.

Such negative perceptions of early stage venture capital held by limited partners, together with their positive view of buy-outs, encouraged numerous early stage venture capital professionals to move upwards within the investment stage. Some

² <http://www.nvca.org/pdf/07nvcapredictions.pdf>

³ VentureSource

created late stage venture capital funds and others formed technology-focused buy-out vehicles that would target the tremendous market of lower-mid market technology companies, with respectable revenues and earnings and a high growth potential.



Source: Dow Jones Private Equity Analyst - Sept. 2007

Many pure-play Tech Buy-Out groups were able to raise a dedicated fund, as a blind pool of capital, while others operate in the form of a pledge fund, working with a group of limited partners, financing each deal individually.

Even though pledge funds do not have their own pool of capital and rely on another layer of decision making to make binding offers, they are not to be neglected as potential buyers. Pledge funds are hungry for deals and are often willing to pay a premium to secure a transaction. Many established private equity groups started as pledge funds until they raised their own pool of capital.

6. TECH BUY-OUT SEEN BY LATE STAGE VENTURE FIRMS

Since the burst of the bubble, a number of venture capital groups have turned away from the high levels of risk associated with early stage investing, and focused on more mature companies with a proven business model and revenue stream. In addition to risk reduction, late-stage investing has the benefit of allowing General Partners to deploy more capital at a faster pace, which results in more favorable economics for the GP.

The concern with late stage venture investing is that deal opportunities with outstanding growth potential are often at astonishing valuation levels, requiring a front-page news making exit in order to generate top quartile returns. For

example on October 24th 2007, Microsoft announced the acquisition of a 1.6% stake in the popular social-networking web site Facebook for \$240m, which valued the 3 year-old start-up company at a stunning \$15b. In addition, late-stage venture investors find themselves with a less diversified and more concentrated portfolio, with fewer portfolio companies to whom they have written bigger checks.

Generally speaking, venture funds are allocating larger sums to invest in more mature companies. Recently, Bridgescale Partners, Sequoia Capital and Draper Fisher Jurvetson have raised new growth funds. New Enterprise Associates, which closed one of last year's largest funds at \$2.5b, plans to spend half of it on what it calls "venture growth equity".

Late stage venture investing is a market of its own. Brand name multi-billion dollar stage-agnostic venture capital firms will most likely continue to be successful at it, in part because of their unique deal flow, their network of relationships and their access to talent. However, access to outperforming investment opportunities in the late stage space is increasingly challenging for smaller dedicated funds.

Tech Buy-Out investing is therefore a natural fertile ground for late stage venture funds and growth capital funds to look for investment opportunities.

7. TECH BUY-OUT SEEN BY LOWER-MID MARKET BUY-OUT FIRMS

The recent credit squeeze and the resulting difficulty to secure a high leverage, means Buyout funds must deploy a higher proportion of their equity stake in order to complete a transaction. At the same time, the amount of capital raised by buy-out firms in recent years, together with fierce competition among firms to secure transactions is pushing them to look at smaller transactions where they feel they can add value to the company and generate returns through value creation, instead of mere financial engineering.

Mid-market buy-out firms invest in profitable companies, and there is no lack of these in VCs' portfolios. A study by VentureOne in August 2006 found that 25% of venture-backed companies in the United States were profitable. The percentage was 30% among those companies that received their initial financing in 2000.

In recent years, many buy-out firms have specialized in specific verticals, such as consumer products, retail, energy or technology, and health care. Vertical specialization is meant to put forward the added value of the private equity group through their market knowledge and network of relationships, versus generalist groups who are perceived to have a financial engineering approach.

8. EXAMPLES OF TRANSACTIONS

October 2007

Silver Lake, a private investment firm with a leading market position in value-added investments in technology, technology-enabled, and related growth industries, has acquired a majority stake in Mobile Messenger, a leading global provider of technology and services for mobile content management and distribution. No financial details were disclosed.

October 2007

Occam Capital, a newly raised expansion stage private equity group, focusing on high-growth, information technology-enabled companies, sponsored a management buyout of Irium, a France-based provider of ERP software solutions for heavy machinery companies.

July 2007

Advent International, a global private equity firm, acquired a majority stake in Sophis, a leading provider of cross-asset, front-to-back portfolio and risk management software solutions. The value of the transaction was not disclosed. Sophis' 2006 revenue was €46m.

December 2006

Vista Equity Partners, a private equity firm that focuses on software and technology businesses, acquired SirsiDynix, the leading automation vendor used by public, academic, and school libraries.

October 2006

TA Associates, a Boston-based firm that was acquired by eDreams, a Spanish on-line travel company for \$195m. eDreams' backers, including Apax partners, Atlas ventures, DCM and 3i had committed \$35m to eDreams.

August 2006

Francisco Partners a technology-focused private equity fund, acquired Ex Libris, a library automation vendor. The acquisition would enable Ex Libris to continue expanding its geographical reach and explore acquisition opportunities for complementary products in the library automation and e-resource markets.

February 2006

Atlanta-based Agentis Software, a developer of business process management tools completed a management buyout backed by private equity firm Modena Technologies Capital Partners, LLC. Agentis Software had raised \$25 million in venture funding since 2001.

9. TARGET COMPANIES

Buy-Out Tech is not a suitable exit scenario for all venture-backed companies. The target company must meet a number of revenue and earnings criteria to fall in the gray zone where late stage venture crosses the line with the operating scope of buy-out funds, and hedge funds.

Listed below are some of the necessary criteria that must be met if a company is to fall in the sweet spot of financial buyers. Of course, these should be taken as guidelines and nothing is set in stone, and there are probably as many variations of the rule as there are transactions.

9.1. REVENUE

The ideal target company has a solid revenue stream in the \$20m to \$100m range. The revenue stream needs to be based upon a proven business model.

Below the \$20m mark, the company is still considered “early stage”. Beyond the \$100m mark, the company will continue being a target for Tech Buy-Out funds, but at that level of revenue, it will have other liquidity options as well.

The company must show significant growth in the past years, and a potential as well as a strategy for significant growth in the future.

9.2. EARNINGS

The target company must be cash-flow positive. Earnings must be steady and show management’s ability to keep costs under control and generate a profit. A subsequent business plan may suggest further investments where the company takes another dive into the red, but at the moment of the acquisition, it must be profitable.

9.3. MANAGEMENT

Tech Buy-Out funds are for the most part financial buyers, who have no desire and no time to run the company in place of the current management. This statement implies that:

9.3.1 A MANAGEMENT BUY-OUT IN THE SPIRIT

A Tech Buy-Out transaction is necessarily some variation of a Management Buy-out. A financial buyer cannot do much without the Management; therefore if the Management won’t stay on board, there is no transaction. If Management wants to let go of the company, then a strategic buyer is a more suitable liquidity event.

9.3.2 RELATIONSHIP BETWEEN BUYERS AND MANAGEMENT

Financial buyers are in the business of adding value to the company, helping it grow, and eventually selling it at a multiple of the acquisition price. They rely on Management to show that they believe in the future of the company, that they share the same goals as the new Buyers and that they agree on the strategy of how to achieve those goals. Therefore, for a Buyer, Management constitutes undoubtedly the most valuable asset in the company. Thus the ideal target for a Tech Buy-Out has a strong management team, with a proven track record and there must be a good fit between Management and the Buyers.

9.4. INTERNATIONAL OPERATIONS

A company with a local business will most likely only attract local buyers. Since the Buy-Out Tech segment is an emerging subset of the private equity asset class, a local business will have a handful of financial buyers, if any at all, who would consider the company as an acquisition candidate.

In contrast, a company with a significant international component to its operations will attract the attention of global players, and private equity groups from other parts of the world who believe they can add value to the company. For instance, a European company with significant operations in the United States will attract the attention of US-based private equity groups who can use their network of relationships in addition to their capital, to help the company grow and reach new levels of success.

10. ACTIVELY SEEKING A TECH BUY-OUT EXIT

The sale of a technology company traditionally has signified seeking liquidity through strategic buyers. M&A assignments were rightfully granted to investment banking boutiques who specialized in a particular vertical, and which could leverage their industry knowledge and network of relationships among strategic players within that particular vertical. An acquisition by a financial buyer has been the exception to the rule.

Actively seeking liquidity through financial buyers is a different game and obeys different rules:

- A financial buyer will deploy the necessary time and resources to look at a deal only if the firm believes that i) the deal is within its sweet spot, ii) the deal is attractive and it can generate adequate returns, iii) it has a fair chance to complete a transaction.
- If a deal is perceived as “over-shopped” and the word is on the Street, no matter how attractive the deal is, most firms will believe that they have little or no chance to complete it, which results in significantly less appetite for the deal, endangering its successful completion. A deal perceived as proprietary or as shown to a limited number of select buyers will attract the maximum level of attention. In contrast, if the deal fails to attract a sufficient number of strong bidders, there will be significantly less competitive pressure, resulting in a lower sale price.
- The “Know Your Customer” principle applies to financial buyers as it does in any other business. One cannot successfully complete a transaction with a particular financial buyer if one does not understand their business model, the way the firm adds value, their own constraints, their expected returns and what they look for in a deal.
- The most scarce and critical resource with financial buyers is their “Attention”. It is quite common that a deal fails to attract a buyer’s attention if it is not introduced through appropriate channels.
- The key success factor in actively seeking liquidity through financial buyers is a fine art, which requires extensive knowledge of financial buyers, their investment strategy and their sweet spot, as well as the right level of access to the firms to be able to capture their attention. And this cannot be achieved by traditional industry-focused M&A boutiques. Instead, one should look to an investment banking firm with a focus on private equity and venture capital.

11. CONCLUSION

Normally, a trend starts as a series of isolated events. At RainMakers Private Equity, we strongly believe that the acquisition of technology companies by financial buyers is a trend in the making because of fundamental needs and inefficiencies in the private equity and venture capital asset class.

We hope that this document has successfully highlighted some of these fundamentals. As is the case with every trend, the greatest gains are to be made at the outset when the trend is in the making. We believe now is the best time for venture-backed companies to seek a liquidity event through financial buyers, i.e. Tech Buy-Out funds.

12. ABOUT RAINMAKERS PRIVATE EQUITY

Rainmakers Private Equity is an investment banking boutique focused on the recapitalization of private equity funds and secondary transactions.

Since 2004, RainMakers has distinguished itself by innovating in the secondary market, closing several sell-side, buy-side and GP-Side assignments and has built a reputation for timeliness, discretion and ingenuity.

RainMakers can help a GP return money to LPs, refresh their LP base, raise new funds, buy time for promising investments, re-focus money on strategic investments and realize exceptional returns on non-strategic investments.

With offices in San Francisco and Paris, RainMakers Private Equity uses its extensive network of relationships which span various segments of the asset class, in the United States, Europe and the Middle East to bring satisfaction to our transatlantic clients and partners.

For more information please visit our website at www.rainmakerspe.com or contact us directly at contact@rainmakerspe.com.