

News Analysis

YEAR IN REVIEW: DEALS

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Mobile, media, mundane to highlight New Year

It's a dream of every venture capital firm: Seed a startup and sell it for more than a billion dollars in less than a year.

For Sequoia Capital, dreams do come true. The firm's sale of YouTube to Google for \$1.65 billion in stock was the standout venture event of 2006. "YouTube was the deal of the year, if not the deal of the decade," says Bart Schachter, managing director at Blueprint Ventures. Sequoia seeded Chad Hurley's video sharing startup with \$3.5 million in November 2005 and put in another \$8 million in April 2006. Assuming it owned at least half of YouTube, Sequoia made 71 times its investment—and that was before Google's stock price shot up by more than \$50 per share.

Highlighted by the YouTube exit, 2006 marked the full-blown return of Internet investing, a trend that started to reemerge in 2005. Investments in Web-related companies hit a four-year high in the third quarter. A year-end tally couldn't be completed by press time in mid-December, but VCJ projects that about \$4 billion was invested in more than 600 Internet deals in 2006, up from \$3.1 billion in less than 500 Internet deals in 2005. *(VCJ's projection was based on data from the MoneyTree Survey by PricewaterhouseCoopers, Thomson Financial and the National Venture Capital Association.)*

The growth in Web 2.0 deals was part of an overall surge in deals. VCJ projects that the total for 2006 topped \$26 billion invested in more than 3,400 deals—a healthy jump from less than \$23 billion invested in about 3,100 deals in the prior year.

Clearly a big year

Several mega deals boosted the annual tally. The year's biggest deal was a \$1 billion investment in WiMax service provider ClearWire led by Intel Capital and Motorola Ventures. Given their capital intensive nature, communications deals accounted for six of the year's 10 biggest venture investments. The other hot sector was cleantech, which had two deals in the top 10. Cilion, an operator of ethanol plants, pulled in the second largest round of the year—\$209 million from Khosla Ventures, Western Milling and Virgin Fuels.

Other popular areas of investment in 2006 included on-demand software, mobile content and even seemingly saturated sectors like instant messaging. VCs also started to broaden their horizons, with firms such as Draper Fisher Jurvetson, DCM-Doll Capital Management, Greylock Partners, Norwest Venture Partners and Sequoia chasing deals around the globe.

So what does 2007 have in store? We asked IT-focused venture capitalists to gaze into their crystal ball to come up with the following 8 trends for the New Year:

Mobile 2.0. The coming year could see the rise of next-generation mobile services that go way beyond voice and email, and start to encompass intelligent services such as location-aware social networks. These services are attractive to VCs because they have the potential to change the way we work and live. For instance, if you are at a business conference or a baseball game and want to know who else is there, you could scan your buddy list and see that a friend is sitting 10 rows behind you.

“The mobile environment is all about delivering very pertinent information that can be immediately acted on,” says Sanjay Subhedar, general partner at Storm Ventures. “I can imagine driving around San Francisco and being able to quickly find the nearest parking space based on where I am at that moment.”

The search continues. Search is “far from being done,” insists Janice Roberts, managing director at Mayfield Fund. She says Mayfield anticipates seeing the next generation of search as well as many vertical offerings in this sector in 2007. In a similar vein, she believes there is still plenty of life left in traditional ecommerce sectors like travel and dating. “We will see the rise of more companies that move beyond the domestic market to target global consumers,” Roberts says.

Bank on security. Every new Internet wave has featured the same pattern of behavior. First, a flurry of interesting applications are created, with no one bothering to bake in security. And then, when the whole thing is ready to come crashing down, like it almost did with email, a wave of security vendors comes to the rescue. Many of these security companies go on to build very lucrative businesses.

Some VCs say they wouldn't be surprised if the same thing happened with next-generation Internet and mobile applications such as VoIP and video. “Security will come back on the radar screen in 2007 because it is still a real issue,” says John Balen, general partner at Canaan Partners. “It took a back seat in 2006, but there is always the need to increase protection.”

A new model for media. There is a tremendous disconnect between how media is being consumed and how it is being produced and distributed, argues David Stern, venture partner at Clearstone Venture Partners. Content is not available where and when consumers want it, he says. And very little is being done by big media companies to address this problem.

The upshot? This year will see the creation of “new technology companies for delivering content and advertising wherever the audience is,” says Stern. It could also mean new advertising agency models as well as new gaming environments that blend offline and online experiences and create new advertising vehicles. Stern says he is confident there are “venture scale opportunities in these areas in 2007.” (*For more on this trend, see the cover story “Extra! Extra!” in the November 2006 issue of VCJ.*)

On-demand goes public. When it comes to on-demand software (aka software as a service), we are still “in the first inning of a double header,” says Brian Jacobs, general partner at Emergence Capital Partners. He adds that there are only 10 to 15 publicly traded on-demand software companies, a very small number compared with enterprise software companies.

Jacobs says this could be the year many more on-demand companies achieve an exit. He also sees 2007 as the year when on-demand companies start offering a full suite of applications, instead of just point solutions. “This means more mergers and acquisitions, as well as more partnering between companies,” he says. “You’ll be able to click a button and get many applications to work together, even if they’re provided by different companies.”

Renewable energy lights up. Venture capitalists expect 2007 to be a huge year for energy. In a survey of 207 venture capitalists by the NVCA in December, 91% of VCs said they expect to see increased investment in that sector. That’s a much bigger increase than they foresee for any other segment. In fact, just two other sectors were predicted to see investment growth in excess of 50%: Internet specific deals (70%) and media/entertainment (69%).

Within the cleantech space, we will see a growing number of companies focused on renewable energy production, says Alain Harrus, venture advisor at Crosslink Capital. “We have reached a point in time where the advances in materials and production technologies are bringing economic parity of electricity production within sight of the conventional methods, mostly fossil fuels-based,” he says.

Harrus also believes 2007 could bring major innovations in the generation of light. “The incandescent light bulb has not changed since 1875,” he says. “New high-volume manufacturing methods applied to new materials that convert electrons into photons are redefining the lighting landscape, from refrigerator doors to ceiling lights.”

Boring is back. Sexy consumer applications and digital media has been all the rage for several years, but the pendulum may swing back to neglected infrastructure deals. “People have been running away from semiconductor and equipment deals, but they might start embracing them again in 2007,” says Schachter of Blueprint. Over the last few years hardware developments have not kept pace with software developments in consumer electronics, he contends. “How many handsets are actually GPS-enabled or simply have enough battery power or a big enough screen to handle all the services out there?” he asks. “We have seen the future of how we want to communicate, but we are

doing it on a handset architecture that is five years old, so we will soon start to see new innovations here.”

India grows up. Promod Haque, managing partner at Norwest Venture Partners, believes India will be more tempting than ever. He expects to see a lot of activity in two particular segments: consumer Internet and second generation services and products. The opportunities in the local consumer markets are being driven by growing broadband penetration combined with a sizeable middle class with tremendous spending power. Haque points out that India’s booming middle class has about \$420 billion to spend.

“We are also beginning to see the maturity of the second generation services market,” he says. “This sector is not solely focused on information technology companies. It also includes attractive investment opportunities in the areas of embedded systems, semiconductors, pharmaceuticals, medical devices and other knowledge-based outsourcing.” Finally, he believes 2007 will be the year when original, home-grown products begin to germinate in India.

Chindia surges. China and India will grow like mad in the New Year. That’s the overwhelming assessment of the 207 venture capitalists surveyed by the NVCA in December. They expect VC investment levels to surge by more than 90% in both countries. The region with the next-highest growth rate? “Other Asian” countries.

But for all the hype about India and China, a few VCs expect those markets to get tougher in 2007, prompting some of their colleagues to come back home. “I predict that we’ll start seeing some failures emerge,” says Jacobs of Emergence. “The rate at which the industry has gone international is not sustainable.”

Jacobs recalls his own unpleasant foray into international VC in the early 1990s. “I once spent months on an investment in the Czech Republic only to learn at the last minute about a very small minority shareholder who could block the whole deal,” he says. “There are so many foreign regulations and fundamental differences that make these deals much harder.”