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Facebook, Twitter and peers for sale - privately

By Rachel Metz

Scott Painter makes his living betting on startup companies, having played a role in launching 29 of them over the years. But with the bad economy choking initial public offerings and acquisitions, Painter is now backing an idea that makes it easier for insiders like him to sell shares in their companies even before they go public.

SharesPost, which was founded by Painter's business partner, Greg Brogger, launched publicly in June. Through SharesPost's Web site, Painter is trying to sell shares in several companies he helped found, including car pricing startup TrueCar.com. He also wants to buy shares in companies that are far from an IPO, like short-messaging site Twitter and business-networking site LinkedIn.

SharesPost is one of a few private stock exchanges that are emerging to fight what venture capitalists call a liquidity crisis. These exchanges give stakeholders an alternative way to trade their shares in hot startups like Facebook for cold, hard cash — without having to wait years for an IPO.

Employees at startup employees often put in long hours but get salaries that can be 20 percent less than their peers at public companies. In return, they get stock or options that they hope will be a path to sports cars and summer homes after their company goes public or is bought out.

Given this, services like SharesPost could help startup workers get some cash while awaiting a distant IPO that might never even get off the ground. Most people won't be in on the action, though, since these exchanges are only open to a small pool of buyers.

And it's not clear how much — or how little — stock has changed hands through them. In its short life, Santa Monica, Calif.-based SharesPost said it has executed one \$25,000 transaction, while another service, New York-based SecondMarket, said it has completed about 40 transactions in the past year worth about \$150 million.

Still, if they manage to thrive, these exchanges could help the economy. By selling shares on a private exchange, an investor can free up funds to put into other startups. And institutional investors could use these services to broaden their holdings to include fast-growing companies that have yet to go public.

The methods of these private exchanges vary. SharesPost uses an online bulletin board to introduce buyers and sellers. SecondMarket links the parties and lets companies set up their own mini-markets that they control, while Redwood City, Calif.-based XChange is rolling out an online system that will allow buyers and sellers to connect and directly trade shares for cash.

All are open just to institutional investors — organizations like venture capital firms or pension funds that manage at least \$100 million in assets — and individual accredited investors. That category includes people with a net worth of at least \$1 million, or salary of at least \$200,000 for the last two years.

The concept is not entirely new. Nypex, formed in 1998, facilitates private-company stock trades, and a few companies with similar offerings emerged during the last economic downturn but failed to gather much steam. Among the problems: Determining a fair price for a private company's stock is tough without much public information.

This time, however, employees and investors are more aggressively looking for a way to get a return on their dedication and funding. More than a dozen companies have priced IPOs in the U.S. this year, down from 35 in the first half of 2008, according to research firm Renaissance Capital. In the same period of dot-com-crazy 2000, there were 219 IPOs in the U.S.

Besides the economy, startup investors say the high costs and regulatory requirements associated with going public have also stymied many smaller, younger companies. According to the National Venture Capital Association, the median span from a company's founding to its IPO was 9.6 years in 2008. In 1998 it was 4.5 years.

One factor is compliance with the Sarbanes-Oxley anti-fraud law, which was enacted in 2002 after accounting scandals at companies like Enron Corp. and WorldCom Inc. A key part of this law requires public companies to file reports on the strength of internal financial controls and fix any problems — steps that can be costly for a startup.

Issues like this have "just made it more and more difficult for companies to make it to that next step," said Thomas Foley, chief executive of XChange, which he developed with venture capitalist Tim Draper.

SharesPost founder Greg Brogger believes his site has one solution to the slowdown in IPOs: Bulletin boards for more than 100 startups that allow buyers and sellers to post the price and number of shares they want to purchase or unload, and the ability to e-mail one another directly.

Parties wishing to make a deal can find the relevant contracts on the site to sign, and an escrow company completes the transaction, charging both sides \$2,500. So far, a \$25,000 deal — the site's minimum transaction size — has been completed for 2,500 shares of electric car startup Tesla Motors at \$10 apiece.

That reflects a great deal of optimism for a company that has only sold roughly 500 cars and had to get additional funding from the U.S. Energy Department. A report from one of SharesPost's research providers, NeXt Up Research, valued Tesla at \$1 billion, or \$9 per share. The car company had no comment.

Anyone can sign up for free to see startups listed on SharesPost. Only qualified investors can buy shares, and SharesPost makes money by charging buyers and sellers \$34 a month.

XChange, meanwhile, enables buyers and sellers to share confidential information necessary for making informed purchases, and it has a platform for users to trade shares. When it is fully launched later this year, XChange will be an automated online exchange, much like E-Trade, where users can instantly trade shares for cash.

But while these services may be able to speed up dealmaking, users must still grapple with another key issue: how to determine a fair price for stock in a company that isn't required to regularly disclose its financial information and doesn't have that many potential buyers or sellers.

At SharesPost, Brogger wants to solve the problem by offering as much information as possible about companies it lists, from analysts at Next Up Research and VC Experts. SecondMarket CEO and founder Barry Silbert said companies can decide to share some details with investors and potential bidders on his site.

SharesPost doesn't believe the research on its site will cause any problems should the company file for an IPO with the Securities and Exchange Commission, as these types of analyses are published by investment banks during the IPO process.

Still, the lack of public disclosure and limited number of traders on these services makes Kathy Smith bristle. A market with limited transparency, participation and disclosures "is not a solution to the markets we have now," said Smith, a principal at Greenwich, Conn.-based Renaissance Capital.

And trading is not always as simple as posting a sales opportunity and an asking price. Startups often restrict what their employees can do with their shares and stock options — commonly imposing the "right of first refusal." That generally means employees who find buyers for their shares have to let the company decide if it wants to buy the stock back instead, for the same price. Companies can use this stipulation to keep competitors from snagging a stake.

Even if these services help startup employees and investors, they're not likely to eliminate the need to someday go public.

For one thing, this kind of market can only get so big. Private companies with more than \$10 million in assets are required to file annual reports with the SEC if they have more

than 500 shareholders of record. This rule prodded Google Inc. into filing for its IPO in 2004, and it could happen to others as these exchanges distribute shares among more shareholders.

Several of the private exchanges say it's up to companies to keep track of their total shareholder count. Foley said XChange helps companies keep tabs by revealing who their shareholders are at any given time.

Another reason IPOs won't vanish: Companies usually go public first to raise cash for their operations, and then to set a price that will eventually let insiders turn their holdings into cash. While some of the private exchanges do let startups themselves — and not just their employees and investors — sell stock, it's not likely to be lucrative without a large base of potential buyers.

Still, some buyers, sellers and startups may see trading through these services as the way to go until the IPO market improves.

"At the very least, it's going to be spring training for companies before they go public," SecondMarket's Silbert said.