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New Path to Liquidity

By Joanna Glasner

Facebook, Tesla and Twitter are among the VC-backed companies whose shares are being offered on emerging private exchanges

A year or so ago, venture investors griping about the miserable IPO and M&A climate virtually always included a lament about the lack of alternate ways to generate liquidity from private company stock.

Today, they may have the opposite complaint. Three quarters after venture-backed IPO activity hit a 28-year low, the emerging market for private share sales is already suffering from what some might call a startup glut. At least four companies have launched efforts in the last year aimed at facilitating such sales to accredited individuals and institutional investors.

The most prominent upstarts are InsideVenture, SecondMarket, SharesPost and XChange. Each pitches services designed for slightly different transaction sizes and deal structures. However, each is targeting the same core sellers: stakeholders in later stage private companies in search of short-term liquidity. Though transaction pace has been slow to date, venture investors—who fit squarely into that core seller camp—are keeping a watchful eye.

"There's a great sense of pragmatism in the industry right now, and there are people who have been in deals for a long time or who are tapped out and would like some liquidity," says Dixon Doll, general partner at DCM and a supporter of the private share exchange concept during his tenure as chairman of the National Venture Capital Association last year. While he doesn't envision exchanges generating "blockbuster transactions" involving top-tier firms in the near future, Doll says he does believe they'll gain some traction among company founders, key employees and investors facing pressure to exit.

Speaking a month ago at a conference in Palo Alto, Calif., founders of InsideVenture, SecondMarket and SharesPost said they've collectively signed up well over 200 companies to participate in their respective efforts. With the time span from initial venture funding to IPO exit currently averaging 9.5 years for startups, companies that

have aspired to be publicly traded—including household names like Facebook—are increasingly looking at shorter-term liquidity options.

For now, however, Greg Brogger, CEO of SharesPost, says he expects VCs will look at the exchange more as an option for long-term holdings, particularly funds that first began investing during the dot-com boom.

"The old way of thinking of venture capital firms justifying their existence through their companies' IPOs is going away," Brogger says. With some 250 funds launched in 1999 reaching their one-decade anniversary, he says, VCs are under increasing pressure to wind down aging portfolios.

SecondMarket CEO Barry Silbert says that Facebook's decision to delay a possible IPO and to sell shares to private investors was also "somewhat of a turning point." Since then, he says, "We've seen a real increase in the number of private companies, even later stage than Facebook, who are saying: 'I don't want to go public.'"

The New Plan B

Such sentiments may be due to private companies deciding it's better to be the rejecter than the rejected. Public markets were inhospitable through this winter. And although this year has already seen more venture-backed IPOs than last year, the long dry spell has motivated private investors and portfolio company executives to develop a more thorough "Plan B" for generating liquidity.

New exchanges offer a panoply of options to do that. From straight person-to-person sales of shares, to a more elaborate matchmaking effort orchestrated to attract strategically aligned institutional investors, private company stakeholders can pick the approach that suits them best. To date, it's tough to say which they favor most.

InsideVenture, which focuses on deals between pre-IPO companies and buy-and-hold oriented institutional investors, recently launched a product for late stage startups called a hybrid private-public offering. Abbreviated as HPPO (pronounced "hippo"), this is essentially a deal between a company and an institutional investor that agrees to put money in both a late stage private round and a subsequent public offering.

Unlike most private stock-focused exchanges, which are primarily Web-based, Inside Venture is all about face-to-face meetings. The company had its first gathering this spring, bringing together late stage companies and institutional investors. InsideVenture CEO Mona DeFrawi says the Menlo Park-based company is currently in discussion "with a couple dozen companies" looking to participate in HPPO deals.

SecondMarket, which launched an online service for listing private shares this spring, operates what Silbert calls a "company-controlled marketplace." Companies create a profile on the site and decide how they want to sell shares. For example, a company may open bidding to any qualified investor or just reach out to select investors. Companies

also have the ability to negotiate price and let employees opt-in to sell shares. New York-based SecondMarket had signed up about a dozen companies as of the end of July, with another 15 or expected join in coming weeks.

SharesPost, based in Santa Monica, Calif., launched its site for connecting private share sellers and buyers in late June. Brogger says the site currently maintains bulletin board listings for roughly 200 later stage private companies and has signed up several thousand users. Venture-backed companies listed on SharesPost include eHarmony, Facebook, Linden Lab, LinkedIn, Slide, SolarCity, SugarCRM, Tesla Motors, Twitter and XCX. In addition to listing share prices, the site provides estimated valuations for those companies, and shows prices of completed transactions. Brogger says blocks of shares for sale range in value from \$25,000 to \$5 million, with the typical block priced at about \$350,000.

XChange, unveiled in May, uses a Dutch auction system to price and distribute share private shares to accredited investors. Under that mechanism, all bidders are able to buy shares at the lowest price at which all shares offered may be sold. Redwood City, Calif.-based XChange isn't actively selling shares yet, focusing instead on creating a platform that it expects to launch later this year. It hopes to offer a series of services, including Dutch auctions, a virtual trading floor to broker sales of private securities to qualified institutional buyers, and a matching platform that links potential buyers and sellers of restricted securities.

VCs in Stealth Mode

Normally, venture capitalists are all about first mover advantage. With private exchanges, however, firms are taking a largely wait-and-see approach. Overall, venture capitalists interviewed by VCJ were generally favorable about the concept of private share exchanges. But the consensus is that there are still some kinks to be worked out.

Some wonder if the nascent marketplaces will be popular with their intended users. "I think the exchanges are good for VCs; they provide liquidity and that's a good thing for our business," says Fred Wilson, managing partner at Union Square Ventures. "My biggest concerns are whether the privately held companies will want to actively list their shares on these exchanges. To date, I have not seen much interest from them in doing so."

Venky Ganesan, a managing director at Globespan Capital Partners, sees private exchanges creating an important new liquidity path for venture capitalists. However, he also believes that, if successful, they could have some detrimental effects on the asset class.

"Like motherhood and apple pie, liquidity and transparency is always a good thing," he says. "Private exchanges are basically pulling the veil of private companies and giving everyone a peek." While today private exchanges are targeting common and small shareholders, he says, there is no reason why this cannot be an avenue for VCs to also sell some of their stakes, particularly older funds.

Ganesan says the biggest downside he sees from private exchanges is the potential introduction of a short-term trading mentality. "You can now imagine that with this liquidity people start trading in and out of fads and stop building companies of enduring value," he says. "Instead of focusing on the right long-term decisions, VCs (and entrepreneurs) might be tempted to do short-term things that are faddish and cash out."

SharesPost Profile

Profile: SharesPost
Location: Santa Monica, Calif.
Launch date: June 2009

Business: Operates what CEO Greg Brogger calls an eBay for private company shares. Sellers and accredited buyers of private company stock list bid prices on the SharesPost website and consummate transactions for a fee.

Participating companies: Maintains bulletin boards for roughly 200 late stage private companies. VC-backed companies listed on website include eHarmony, Facebook, Linden Lab, LinkedIn, Slide, SolarCity, SugarCRM, Tesla Motors, Twitter and XCX.

Participating investors: Has more than 6,000 registered members, though most do not currently pay the \$34-per-month fee SharesPost charges to list bids on its site.

Target companies: Private companies with annual revenue between \$100 million and \$500 million.

Other details: Bid posts range from \$25,000 to \$5 million with an average of about \$350,000. U.S. Bank charges a flat fee of \$2,500 to both the buyer and seller for processing the transaction. SharesPost also publishes reports, including valuation estimates. Reports were available for at least 50 companies as of August.