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Secondary Marketplaces Showing Signs Of Finding Their Niche

By Russell Garland

While venture investors await further signs of life from the public markets, a growing market for private company shares is fueling secondary marketplaces launched last year by SecondMarket Inc. and SharesPost Inc.

But the direct secondary business remains opaque and it's still unclear how much of the market either company or other potential entrants will be able to capture, and whether their electronic marketplaces can drag the industry into the 21st century.

For a time there seemed to be an explosion of new marketplaces for shares in venture-backed companies triggered by the launch in late 2008 of InsideVenture Inc., backed by New Enterprise Associates and other well-known venture firms who were looking to bring new institutional investors into their late-stage companies. SecondMarket, which has financing from venture firm FirstMark Capital, launched its private company market in April 2009 followed in June by start-up SharesPost. Around the same time, venture capitalist Tim Draper, founder of Draper Fisher Jurvetson, signaled his plans for yet another marketplace, called Xchange.

Soon, however, SecondMarket swallowed InsideVenture and Xchange never really got off the ground. Draper said in an email that the company is "very much in business" and will soon launch under a new name. He declined further comment.

SharesPost and SecondMarket both say they are doing well and while they are competitors, their business models are different. SecondMarket is a licensed broker-dealer that can execute trades while SharesPost is more of an online platform where people looking to buy or sell private company shares can find each other, exchange information and view SharesPost research reports on its listed companies. It partners with brokers to handle trades.

SharesPost Chief Executive Greg Brogger said the company's membership recently crossed the 16,000 mark, up from 7,000 in November. He said \$400 million worth of posts to buy and sell shares have gone through SharesPost since July, a significant portion of them within the last three to four months. In the first two months of this year, members were actively negotiating over \$279 million worth of posts. Initial posts were very small, about \$50,000 on average as people dipped their toes in the market, Brogger said, but now the average is just under \$1 million.

So far most of the sellers are small shareholders – employees, founders and early investors – as opposed to large institutional investors or the companies themselves, looking to raise capital. “I would expect that to continue for some amount of time,” Brogger said, although SharesPost has ambitions to handle bigger transactions. “There’s a long way to go before one can say all the tools and systems are in place to make this a really efficient market,” he said.

SecondMarket said its business is also expanding significantly, with trades in the first three months of this year totaling about \$150 million compared with \$100 million from the market’s launch in April to the end of 2009, said Adam Oliveri, managing director of SecondMarket’s private company market.

Facebook Inc. shares account for more than \$100 million of the trades since April 2009 as ex-employees cash in on the exuberance surrounding the venture-backed company, which last raised capital in May 2009 from Russian investment firm Digital Sky Technologies at a \$10 billion valuation. SecondMarket said Facebook’s market capitalization now is about twice that – more than the combined market cap of the three dozen other companies that have traded on SecondMarket.

Oliveri said that nearly all activity centers around pre-IPO companies that have broad consumer appeal, a phenomenon that he thinks will continue until private companies get more comfortable sharing financial information electronically. Most companies are providing financial information to a maximum of 10 institutional buyers, mainly growth and secondary funds, and SecondMarket’s role is to find the most likely buyers – “Essentially, who is the company not wasting its time with,” he said.

Deals range from \$1 million to \$3 million with a median of about \$2.2 million – about \$1 million if Facebook is excluded. Sellers are mainly ex-employees or founders, and then angels and Series A venture investors, Oliveri said.

For the moment, SecondMarket and SharesPost seem to have found a niche that doesn’t threaten traditional secondary players, who generally look for bigger deals or who find the marketplaces useful. “They help us by showing us more investment opportunities,” said Hans Swildens, founder and principal of secondary investor Industry Ventures. About half the deals Industry sees on the two marketplaces are ones the firm had not seen before, he said.

“We value their deal flow,” of David Wachter, a managing director at secondary firm W Capital Partners. “There’s a market opportunity there.” But he said the firm finds most of its deals directly, not via marketplaces or agents.

The question is the size of the market for these online platforms in a business where personal connections are often essential. Wachter doubts that any part of private equity or venture capital lends itself to a truly liquid exchange. “There’s just too much due diligence that’s required and a level of relationship that needs to take place before any deal can be done,” he said.

SecondMarket's Oliveri said he expects to make inroads, but that it could take five years. The technology and systems are not the problem, he said - the issue is "the ecosystem coming to grips with a new way of doing things."