

VCs say private markets won't push them aside

Venture capitalists provide young firms with more than just money, players say

Venture capital's demise at the virtual hands of the private markets has been vastly exaggerated, industry insiders say.

Word that Securities and Exchange Commission officials might expand trading of private shares to include companies with more than 499 shareholders sparked discussions on whether the expanded private markets would make venture capital obsolete.

Venture capital executives say they shouldn't be counted out quite yet. Money is not the only thing they provide for young companies in which they invest, round after round. Venture capital also provides contacts, expertise and guidance. What's more, private shares are viable only for a small slice of later-stage companies, venture capital firm executives say.

Even if the SEC doesn't expand the private market, activity on the so-called secondary market has been on the rise, in part, due to the development of secondary trading platforms, according to Mark G. Heesen, president of the National Venture Capital Association, a Washington-based trade association.

One of those platforms, New York-based SecondMarket Inc., more than doubled its private trades in the fourth quarter of 2010 to \$157.8 million. SecondMarket facilitated \$500 million in private-company transactions between its launch in April 2009 and the end of 2010, according to its fourth-quarter report, the most recent available.

"We don't think it will replace venture capital," Mr. Heesen said. "The secondary market is a financing transaction."

The poor IPO market over the past few years led venture capital firms to use private markets

as a way to provide liquidity to their portfolio companies, Mr. Heesen said.

Venture capital executives found they were holding companies for a decade compared with the five to seven years they had planned, he explained.

"At that time, venture capitalists thought the private markets were helpful," Mr. Heesen said. "You want to keep entrepreneurs hungry, but you don't want to starve them."

IPOs still needed

Norm Fogelson, general partner at San Francisco-based Institutional Venture Partners, a venture capital firm, does not think private markets will eliminate the need for initial public offerings or venture capital. He said the private exchanges will provide a way for some venture-capital-backed companies to get some cash out of their investments.

"The private exchanges will provide some liquidity for the most visible private companies, but young entrepreneurs will always need venture capital to get started," Mr. Fogelson, said in an e-mail.

Some 39% of the private trades on SecondMarket in the fourth quarter were Facebook private shares — which is no longer an early stage start-up.

Plus, private markets will not topple IPOs or mergers and acquisitions as venture capital firms' preferred exit route.

"IPOs will remain the most popular liquidity event for promising high-growth companies. Our recent IPOs include ArcSight LLC, comScore Inc., NeoPhotonics Corp. and Synchronoss

Technologies. We have several other portfolio companies in registration,” Mr. Fogelson said. “At the same time, M&A will continue to provide significant exit opportunities for a majority of the venture-backed private companies, as it always has for the past 30 years.”

Ira Ehrenpreis, general partner at Palo Alto, Calif.-based venture capital firm Technology Partners, agreed that even an expanded private market is not an exit route for venture-capital-backed companies. “Only a very small fraction is really in that category,” he said.

Private markets are not a viable option for growing companies, he added.

“I do not see the secondary markets as competing with venture capital at all,” Mr. Ehrenpreis said. “When we participate with our companies ... capital is just one of the reasons companies go with us. We also offer our expertise, contacts, business-building acumen. Secondary markets don't help companies in those ways.”

Executives at alternative investment consulting firm Cliffwater LLC, Marina del Rey, Calif., have spent some time looking at private exchanges to separate the “hype from reality,” said Thomas K. Lynch, managing director in Cliffwater's New York office.

“The hype is the access to Facebook, Groupon, Zynga and a few other hot social media companies,” Mr. Lynch said. “The reality of the private exchanges is that they provide a more efficient way for investors to purchase employee shares.”

Competition

Venture capital executives have been buying employee shares of their own companies in privately negotiated transactions for years, he said. Still, “the majority of the investment going

into these companies is still from institutional rounds of venture or private equity financings,” Mr. Lynch said.

The new rules would mean that venture capital and private equity executives will compete with a broader universe of buyers, Mr. Lynch said. And, these transactions are not expected to overshadow the public equity markets or bypass venture capital.

“The reality, we believe, is that the volume of these transactions will still be small in comparison to traditional venture capital rounds of investment,” Mr. Lynch said.

For their part, private market exchanges are not aiming to replace venture capital, said Jeremy A. Smith, chief strategy officer and head of private partnerships market for SecondMarket.

“Venture capital firms are both buyers and sellers” on the private markets, he said.

The \$234.7 billion California Public Employees' Retirement System, Sacramento, is one institutional investor with experience holding private market shares. Officials there favor regulations that would improve the pension fund's ability to invest in private shares.

“Private exchanges have helped us obtain equity stakes in (general partnership) management companies,” spokesman Clark McKinley said in an e-mail.

CalPERS has had equity stakes in a number of private equity firms including Apollo Management LP, Carlyle Group and Silver Lake Technology Management LLC. According to CalPERS' most recent annual financial report, which is as of June 30, the private shares have had mixed performance results.

CalPERS' stake in Carlyle had a market value of \$334 million, nearly double its \$175 million original book value. By comparison, Apollo

Management's market value was \$240 million, half its \$581 million original investment. Silver Lake's market value was \$198 million, below its \$270 million original book value.

"Some of them have recovered from setbacks in the financial crisis," Mr. McKinley stated. "Generally, these are good avenues of investment for us, and we would want any regulatory changes to enhance our ability to make such investments, rather than to limit them. I can't get more specific than that."

SecondMarket's Mr. Smith said executives there welcome any added regulation.

"Regulation is a healthy thing for an evolving market," he said, adding he hopes it would be "rational regulation that makes sense for the growth of the market."

Both Mr. Smith and Mark Murphy, head of public affairs for SecondMarket, were unsure whether the SEC would, indeed, expand private markets any time soon.

"We're encouraged by (Chairwoman Mary) Schapiro's comments that the commission is willing to study the existing rules to determine if they should be modernized," Mr. Murphy said in an e-mail.

The National Venture Capital Association will host on April 29 a webcast for members on what it calls the "secondary market phenomenon." And in light of the increase in private trading as well as venture capital's exemption from filing with the SEC, the NVCA is recommending that all venture capital firms adopt a policy pertaining to their partners and employees to, in part, guard against insider trading on the private markets.