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Secondary Liquidity Drives Real Benefit For The Venture Capital Ecosystem

By Sam Schwerin and Dan Burstein of Millennium Technology Value Partners

We made our first secondary investment ten years ago, buying shares in a venture-backed company from sellers who needed partial liquidity for some very specific purposes. We also made a bold prediction: The direct secondary market for venture capital assets would grow to become a multibillion dollar market sometime in the next decade.

Back in 2002, the total market size for these types of transactions was less than $250 million. Fast forward a decade: As we celebrate our firm's 10th anniversary, the direct secondary market for venture capital assets may break through the $10 billion mark in 2012, with volume already reaching $9.3 billion in 2011.

We see many reasons why the secondary market will continue to grow in the coming years. Companies are proactively seeking to stay private longer, and are able to do so by availing themselves of cash liquidity for their constituents as they mature. Indeed, the secondary market has gone from obscure, unloved and sometimes unwelcomed a decade ago, to become a widely accepted and a fundamental part of the venture capital ecosystem today. The era of the "integrated financing" has dawned: Secondary liquidity is increasingly wrapped up with primary financings, pre-IPO strategies, and virtually every part of the process by which emerging companies address their financial needs.

Facebook Inc. tells us much about this history: Since that company's founding in 2004, significantly more money was invested in secondary purchases of Facebook stock than in all the company's primary financings put together. (Our firm was among the first institutional buyers of Facebook secondaries, beginning in 2008 with a liquidity program for former employees). Precisely because shareholders could always get cash liquidity from the secondary market, Facebook was able to grow into the market cap giant it is today without facing undue pressure to go public before it was ready.

As the secondary market grows, it is undergoing a maturation process. Just recently, the Securities and Exchange Commission took action against several firms that reportedly engaged in a variety of inappropriate practices in connection with secondary transactions. Clearing out inappropriate and illegal practices from the market, and making sure participants understand relevant securities laws, is beneficial. We believe these actions will further fuel the secondary market's maturation as an increasingly institutional business.

The recent JOBS Act (and the new SEC regulations that will follow) will lead to the entrance of a more diverse, less traditional population of venture investors. This fact, alongside the proliferation of marketplaces and feeder funds, suggests that the need for liquidity will continue to grow. Yet these same trends are also creating new complexities, requiring operating companies and their liquidity partners to become increasingly sophisticated and best practices-oriented with regard to the secondary sector.

We have consistently emphasized that forward-thinking companies must "get ahead of the curve" and "take control" of the secondary process. We want to see companies set their own rules for how secondary should be done and we want to work with them as a trusted liquidity partner to provide customized solutions.

The growing role played by secondary when it is done right will drive important win-win benefits across the entire spectrum of venture capital participants. Here are some examples:

– Private companies will continue to grow in the relative calm of the private market while still gaining many of the benefits of being a public company, such as access to periodic liquidity and a valid acquisition currency.

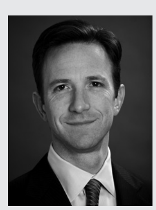
– Company capital structures will gain flexibility in emphasizing different types of investors at different stages. For example, angels crucial in the early days can take some chips off the table after a company has demonstrated success and, through secondary transactions, allow in later-stage investors with different valuation expectations and expertise.

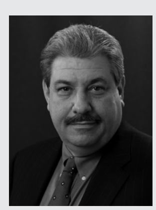
– Employees who might previously have had to wait a decade or more for an IPO now have liquidity opportunities along the way. Companies will increasingly see secondary liquidity programs as powerful tools to attract, motivate and retain talent.

– Venture investors can also obtain partial liquidity, allowing them to achieve better, more sustainable performance. A next generation of more flexible venture capital firms will emerge as industry leaders, increasingly able to provide both growth capital and secondary liquidity throughout the lives of the companies in their portfolios.

– Limited partners will discover renewed interest in the venture asset class by virtue of more diverse opportunities for liquidity, as well as improved risk-return dynamics arising with the introduction of alternative liquidity paths.

We expect the secondary market to continue growing. As it evolves, look for the power of liquidity to trigger a new and strongly virtuous cycle in the venture ecosystem.





Sam Schwerin and Dan Burstein founded Millennium Technology Value Partners a decade ago. The firm has close to $1 billion in assets under management, and has made 300 secondary investments in companies including Facebook Inc., Twitter Inc., Zappos.com Inc., Chegg Inc. and many others. To learn more visit www.MTVLP.com.