The Growing Importance of Institutional-Quality Liquidity Solutions for Venture-Backed Companies

By Dan Burstein and Sam Schwerin

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MILLENNIUM
TECHNOLOGY VALUE PARTNERS

747 3rd Avenue, 38th Floor
New York, New York 10017

The Growing Importance of Institutional-Quality Liquidity Solutions for Venture-Backed Companies

By Dan Burstein and Sam Schwerin, Millennium Technology Value Partners

Upbeat forecasts of the "return of the IPO market" have percolated through financial media of late. Like green shoots of spring, a handful of venture-backed companies have completed successful IPOs recently. One blogger confidently forecast a 25% increase in successful IPO activity for 2010 compared to 2009...without bothering to mention that 2009 was the second worst year for venture-backed companies going public in modern memory (the worst being 2008). After two dismal financial crisis-driven years, a reasonable person would expect 2010 to show an increase in IPO activity, especially with the NASDAQ having nearly doubled from its March 2009 lows and overall U.S. GDP showing key signs of recovery. But a handful of successful IPOs--or even a plethora--does not begin to address the fundamental problem of illiquidity in the venture asset class. Even if the IPO market were to experience much more robust growth than we think is likely over the next 18 months, the liquidity crisis in the venture capital ecosystem will continue unabated. This crisis is systemic and structural, not an aberrational short-term byproduct of the financial crisis. Indeed, even in the booming record-setting market of 2007, which saw the best year for IPOs since the technology "bubble" of the '90s, only 76 venture-backed companies achieved IPOs, out of an estimated universe of 12,000 venture-backed businesses.

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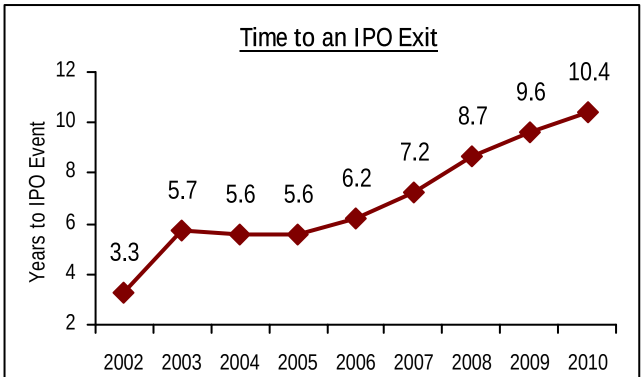
It now takes more than a decade for the average private technology company to go from startup to IPO. Even mythic companies that are thought of as having just arrived on the scene have usually been at it longer than most people think. Facebook, for example, this decade's most astonishing story of rapid growth in a technology business, celebrates its seventh anniversary this year, and has talked down the idea of a near-term IPO.



Source: Dow Jones VenturesSource. Represents years from initial funding to IPO.

For many constituents in successful, high quality technology companies, 10 years is simply too long to wait for cash liquidity. Founders, early employees, senior management team members, angel investors and many others can't be expected to wait a decade to see whether their hard work and early vision is rewarded with a good outcome. Strategic and institutional investors, too, sometimes prefer to have an exit well before the natural course of business development gets a company ready for IPO or M&A sale. With the IPO market still virtually closed (despite all the optimism in certain quarters, there have only been 8 actual successful venture-backed IPOs through the first quarter of 2010), and with the M&A path hardly more certain to lead to acceptable or attractive valuations, the most far-sighted management teams and boards have increasingly looked to the burgeoning secondary market to provide partial, early liquidity to those in their capital structure who want or need it. Many of the most sophisticated venture capital investors who a decade ago might have been skeptical or even opposed to interim liquidity for management or founders now recognize that partial liquidity along the way can help motivate the team, align all constituents' interests, and help set the optimal timetable for success. Moreover, all this can be accomplished through utilizing secondary market liquidity without the pressures of getting into an unknowable IPO process or accepting a sub-optimal valuation in an M&A sale. Interim liquidity is increasingly understood to create value for all shareholders and contribute to de-risking the overall venture ecosystem. As veteran Silicon Valley venture investor Tim Draper has pointed out, "Liquidity transactions make the value in everyone's shares more real and more apparent--even for those who don't participate in the transaction."

For the last decade, Millennium has been pioneering the direct secondary market for venture capital assets. Since 2002, our team has completed about 300 secondary transactions in 50 best-of-breed companies, some of the better-known of which include Facebook, eHarmony, Zappos, LiveOps, Tellme, iPass, Wayport, ArcSight, and Airvana. Many investors have become active in this space over the last few years. Facebook and Zynga did large liquidity programs during 2009, satisfying internal needs for liquidity while remaining private companies. In both cases, the liquidity programs were bigger than most traditional technology company IPOs. In fact, during 2009, the secondary market provided roughly as much liquidity to constituents in private venture-backed companies, than was provided in aggregate by the public markets to those venture-backed companies that succeeded with their IPOs.

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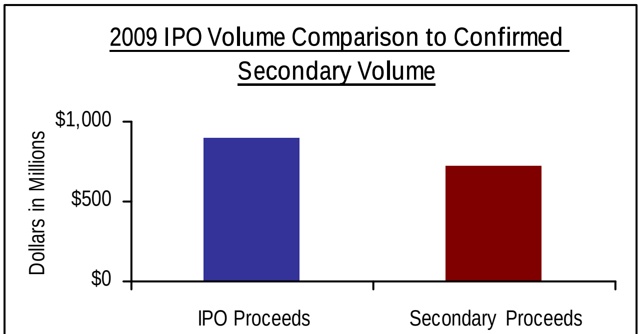
With the growing interest in secondary liquidity, and a new diversity of sources providing liquidity, new issues have arisen. Some companies have been surprised by the behavior of certain secondary players who go through the "back door" to do a deal and attempt to work around corporate institutional rules and practices. In other cases, potential liquidity providers have made a market in a company's stock, without the agreement or support from the company, sharing confidential information, soliciting unsophisticated buyers, and creating a negative dynamic rather than aligning interests. While an optimal institutional-quality liquidity solution allows all constituents the opportunity to achieve their respective objectives and helps instill the kind of patience throughout the capital table often necessary to long term success in venture-backed companies, the wrong secondary buyer can instead create new challenges and distractions for management teams--and in some cases, significant new risks.



Source: IPO proceeds based on Dow Jones VentureSource.
Secondary proceeds includes ONLY large publicly disclosed secondary investments. Does NOT estimate total secondary transaction volume.

Although liquidity solutions may look to be the same from the outside, especially to those who are parched for liquidity, the fact of the matter is that all liquidity is not created equal. As CEOs, CFOs, general counsels, and company boards have begun to think through the strategies and complexities associated with introducing secondary liquidity, they are increasingly concerned with the institutional quality of their partners in potential liquidity transactions. Millennium shares these concerns. We believe in designing liquidity programs with the support and participation of the companies--not in opposition to their interests or in circumvention of their rules. Hallmarks of Millennium's approach include these:

- **We seek to be a trusted, institutional liquidity partner to companies and their constituents.** That means we will work directly with companies to design and affect a breadth of customized liquidity programs. We empower companies to take control of how, when, and to whom liquidity will be offered. By partnering with Millennium, companies can set their own rules of the road for liquidity.

- **We seek to be a medium-to-long term partner/solution provider.** Companies and shareholders appreciate the fact that we are not just trying to execute one opportunistic deal, but that we are building up positions over time and making ourselves available to be the "buyer of first resort" for all participants in the capital structure. Secondary liquidity is not about a single selling shareholder, it's about choosing a trusted liquidity partner to develop both wholesale and specific, customized solutions as needed throughout a private company's life. In fact, Millennium averages more than a dozen transactions per company, allowing key constituents to control how much and over what time period liquidity is achieved. One indicator of how well this model works: 83% of all those who complete one liquidity-oriented transaction with Millennium return for a second transaction or refer a second transaction to us. This "repeat rate" is a sign of customer satisfaction throughout a company's internal structure.

- **We seek to be value-added where added value is desired or needed.** In many of our portfolio companies, we have provided financial and business value far beyond the scope that might be imagined for a secondary investor. These value-added initiatives have ranged from initiating non-dilutive venture loans for companies that need access to additional capital, to introducing important new business partners, to improving outcomes for investors in M&A sale processes.
- **We seek to put our multitude of liquidity-provisioning experiences to work for the benefit of companies and management teams who have not necessarily been through private company liquidity programs before.** We have developed a chest of liquidity tools from organized private company tender programs designed to spread liquidity broadly across the shareholder base, to more targeted uses of liquidity for management incentive and retention programs, to synthetic severance programs, structured approaches to founder liquidity needs, and more. All these programs share common themes of achieving the monetized benefits of liquidity while also using it as a structural tool to better align interests, reduce risk, and prepare a company for an optimal exit, rather than a time pressured one.

The last decade saw the birth, initial growth phase, and visible importance of secondary and alternative liquidity strategies for the venture capital ecosystem. Today, companies, management teams, employees, investors, and boards increasingly understand the uses and value of secondary liquidity. The period ahead will see tremendous growth in the number of companies engaging in secondary transactions, as well as in the total dollar volume. But perhaps most importantly, the next few years will see increasing institutionalization, sophistication, and specialization in providing secondary liquidity. Millennium hopes and expects to continue to be a leader, working with the best companies, deploying the best institutional practices, and achieving the best outcomes for all constituents.


About the Authors: *Dan Burstein and Sam Schwerin are Managing Partners of Millennium Technology Value Partners. Millennium specializes in providing innovative liquidity solutions to venture-backed companies, their founders, management teams, employees, institutional investors, and other constituents. Through 300 transactions over the last decade, the firm has developed unique expertise in the direct secondary market for venture capital and growth equity assets. Some of the companies for which Millennium has created liquidity programs are Facebook, Zappos, eHarmony, Tellme, Wayport, ArcSight, Airvana, iPass, and LiveOps.*

At $280 million in committed capital, Millennium's most recent fund, Millennium Technology Value Partners II, L.P., represents the largest pool of institutional capital in today's market devoted to sponsoring alternative liquidity programs and making direct secondary investments in the world's leading private technology companies.

Millennium is a New York-based family of private equity and venture capital funds that has been making investments in technology companies for more than a decade. Prior to Millennium, Sam Schwerin worked in private equity and M&A at investment firms including The Blackstone Group and Salomon Brothers and has completed in excess of $50 billion of principal investments, mergers, acquisitions, restructurings, and debt and equity financings. He has also helped found several successful venture-backed companies. Dan Burstein was at The Blackstone Group for 12 years prior to founding Millennium in 2000, and has been making venture capital investments since 1983. He is also a bestselling author, having published more than a dozen books on global economics, new technology, and popular culture. To learn more about Millennium visit: www.MTVLP.com