Toward a More Liquid and Efficient Secondary Market for Venture Capital Assets

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The growth of secondary investing has been one of private equity's megatrends in recent years. This trend was originally fueled by the business of trading limited partnership interests in the largest and best-known private equity and venture capital funds. A recent report from Probitas Partners indicates that over $15 billion was raised in 2007 alone for funds specialized in secondary investing.

One of the newer frontiers of secondary market activity is direct secondary investing, meaning buying and selling securities in individual private companies, rather than in bulk portfolios or through limited partnership interests. Particularly new and noteworthy is direct trading in secondaries derived from smaller venture capital-backed companies. This is an area in which our firm, Millennium Technology Ventures, has developed a specialty. Since 2002, we have made well over 100 direct secondary investments in venture capital-backed technology companies, with deal sizes ranging from under $1 million to more than $15 million. **We believe that over the next few years, the market for direct secondary venture capital assets will become a multibillion dollar annual market.**

When sellers turn to the secondary market, they do so for many reasons. Among some of the more frequently cited are:

- a need to generate cash liquidity from illiquid assets. This is particularly true now that the median holding period for venture capital investors to obtain a successful exit has risen to over seven years – twice the length of holding periods at the beginning of this decade.

- a desire to reduce expenses and administrative burden associated with managing non-core assets.

- a plan to reduce, eliminate or meet regulatory, accounting and compliance requirements. In many cases, public companies and mutual funds are finding it onerous to do the type of mark-to-market valuations of small private company holdings that are necessary today, and as a result have begun divestiture programs.

- optimizing tax benefits. For some investors, it is particularly useful to accelerate write-offs through a sale of underperforming investments in companies that are still operating, and where a write-off would not be possible otherwise.

- personal needs on the part of individual founder/executive sellers. These range from diversifying excessive concentration of personal net worth in a single private company, to funding the start-up of a new business, to buying a home, to managing the distribution of assets in a divorce.

- repairing, reallocating or increasing capital bases. Over the last decade, venture capital dollars went into more than 30,000 financing rounds for companies that have not yet achieved liquidity for their investors through an initial public offering or an exit via the mergers and acquisitions process. While the IPO window appeared to be opening in 2007, as of mid-2008, it appears largely closed once again. This frustrating and uncertain situation makes liquidity through secondary market sales particularly attractive to investors as well as to management members who had been hoping for successful near-term IPOs.

What's more, with a rising tsunami of credit market problems—margin calls, paralyzed auction rate markets, defaulting loan portfolios, home foreclosures and collapsing values in subprime and even prime portfolios—numerous kinds and classes of investors will be able to make use of liquidity from their venture capital investments. Over the last several years, hedge funds, private equity funds and even public mutual funds made investments in private, illiquid venture capital-backed companies. Now that some of these funds are facing liquidity squeezes in the areas of their core competency, their venture capital portfolios are seen more as a luxury than as a necessity.

The reality is that, compared to the IPO market and the credit markets, the secondary venture capital market is open and functional.

We believe that the current demand for liquidity will serve as a mother of invention, helping to expand the secondary market and make it more efficient. But the need for liquidity is a constant. It is not just a set of crisis conditions that causes owners of venture capital assets to want to sell them. In fact, there are many reasons for investors to participate in a more liquid marketplace all the time. We intend to continue our firm's efforts to improve liquidity and efficiency in the secondary market in ways we believe will benefit all constituents in the venture capital ecosystem.

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