White Paper

Venture Capital Secondary Funds – The Third Exit Option

A smart way to improve fund performance and unlock hidden value

Hans Swildens
Principal and Founder, Industry Ventures LLC
hans@industryventures.com
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Introduction

The Secondary Market for Venture Capital: Definition

Primary markets are markets in which assets are issued; subsequent buying and selling occurs in a secondary market. Secondary markets create liquidity options for sellers and exist for many different types of assets: securities, durable goods, mortgages, energy, and even tickets to sporting events.

Historically, venture capital was too small a segment within the alternative asset class to support a vibrant secondary market. However recently, the dollars invested in venture capital investments have escalated from $4.9B in 1987 to $29.4B in 2007, an increase of 500% (Source: Venture Capital Journal, PricewaterhouseCoopers). This growth has resulted in a dramatic imbalance between venture capital investments and venture-backed company exits: U.S. venture capitalists invested in 23,935 deals between 2001 and 2007, but only 2700 or 11% of venture capital-backed deals had either IPO or M&A exits during this time period (Source: Thomson Reuters, NVCA, PricewaterhouseCoopers). The resulting unmet demand for liquidity has created an opportunity to support a secondary investment market. A number of secondary firms have emerged to provide timely liquidity solutions to investment partnerships and direct investment portfolios. The chart below illustrates the gap between venture capital investments and venture capital-funded liquidity events from the aforementioned time period.

Figure 1: U.S. VC Investments and Liquidity Events 2001-2007

	2001	2002	2003	2004	2005	2006	2007
Number of Deals	4478	2892	2922	3082	3118	3630	3813
M&A Deals	353	318	291	339	347	363	305
IPO Deals	41	22	29	93	56	57	86
Tot. Liquidity Deals	394	340	320	432	403	420	391
as % of Tot. Deals	9%	12%	11%	14%	13%	12%	10%

Source: Thomson Reuters, NVCA, PricewaterhouseCoopers

Just as venture capital firms focus on specific industries (IT or healthcare) or investment stages (seed, early, development, or late), secondary funds are also organized by investment themes. Three primary types of secondary funds exist:

LP Secondary Funds: These funds acquire investment fund partnership interests.
Direct Secondary Funds: These funds acquire direct portfolios of venture capital investments.
Hybrid Secondary Funds: These funds acquire both fund interests and direct venture capital investments.

Secondary funds often purchase investments from existing shareholders who can no longer fund the ongoing capital needs of their investments or deem the investments non-strategic. Secondary funds also enable early investors to "lock-in" their paper gains, rather than waiting years for a liquidity event to occur.

Other dynamics also influence the need for secondary fund investments. For instance, older vintage funds that approach the end of their partnership terms (typically 10 years) may seek secondary market solutions. In particular, according to Thomson Reuters and NVCA, over 250 new venture funds were raised in 1999 and 2000. These funds are now reaching the end of their partnership terms and have experienced economic headwinds. Consequently, the tails of these funds likely will need liquidity solutions via the secondary market.

In addition, macro-economic conditions may cause a drop in IPO and M&A activity, making secondary market liquidity a more viable option for firms seeking exits for venture-backed portfolio companies. Recent data about both direct secondary and LP secondary activity support this viewpoint: In 2007, direct secondary venture investments in the U.S. surpassed $1.25B — up more than 30%, or approximately 4% of the roughly $30.2B invested in the total U.S. VC market and increasing at a compound annual growth rate (CAGR) of over 30% , according to NYPPE. In addition, McKinsey & Company estimates that between 3-4% of the limited partnership interests in the private equity and venture capital business trade on an annual basis, or approximately $1.2B. Combining both of these figures, the secondary market for both LP and direct venture capital investments amounted to more than $2.45B and represented 8% of all venture investments in the industry. The size of this aftermarket reaffirms that a robust secondary market for venture investments has evolved and is now established.

Today, the secondary market allows venture capital investors to align liquidity solutions with investment objectives similar to those used in other established markets like real estate and lending. Some key solutions in the secondary market for private equity include:

- Achieving liquidity at the optimal time for maximizing internal rate of return;
- Reducing concentration risk and locking in early returns;
- Reallocating and retooling investment strategy;
- Eliminating non-strategic investments; and,
- Creating strategic partnerships to share investment risk and return.

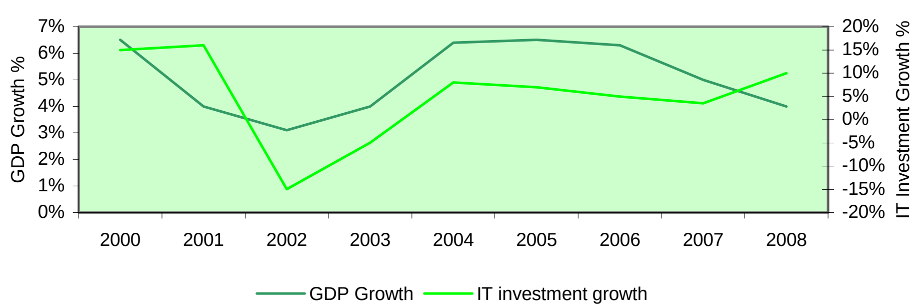
This paper highlights some of the challenges associated with investing in private equity and specifically venture capital, as well as the opportunities presented by the availability of secondary market solutions.

The Macro-Economic Challenge

Limited and general partners contend with a host of different and complex problems. Many of these problems revolve around generating realized returns on their investments. In order to generate upper quartile returns, investors need to produce good IRR and return on capital multiples. These metrics are heavily influenced not only by the relative health of public financial markets but also the ability for strategic buyers to acquire private companies. Over the last ten years, it has become clear that exit opportunities for venture-backed portfolio companies correlate strongly with the state of the economy and its ability to support M&A and IPO market activity.

The chart below from a Goldman Sachs report released April 6, 2008 illustrates how interconnected information technology (IT) investments are to the broader economy. This chart shows that in the post-bubble period (2002-2008), growth in IT investments has a direct relationship to the state of the overall economy. Goldman Sachs reports a correlation of 0.68 relative to a correlation of 0.15 that existed in the 1990s. If this strong correlation continues, exit opportunities for venture-backed IT companies would as a result decline in a weak economy. Consequently, the availability of a secondary market to buy and sell venture capital investments should provide some stability to this market and enable the market to operate more efficiently and effectively.

Figure 2: Growth in IT investment now more closely tied to broader economy



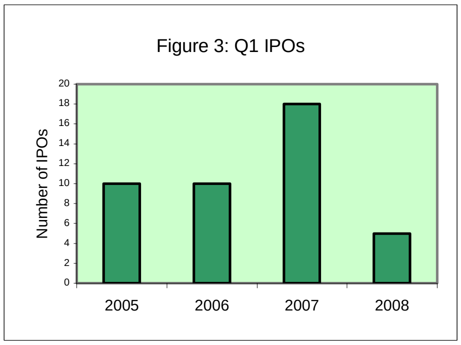
Source: Goldman Sachs

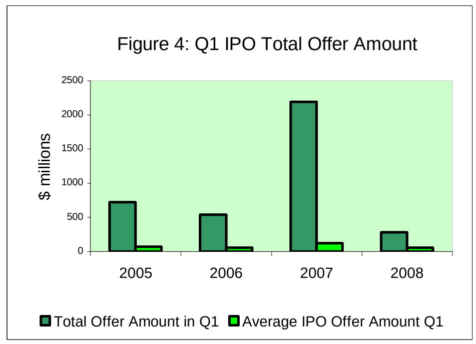
Economic Down Cycles and Mergers and Acquisitions

In 2007, the value of venture backed mergers and acquisitions was $27B as reported by the National Venture Capital Association (NVCA) and Thomson Reuters. During the first quarter of 2008, 56 M&A deals took place as compared to 82 in 2007, a decline of approximately 33%. According to data released by OEM Capital, an investment bank specializing in technology M&A, the current credit crunch and financial distress has dragged M&A activity down over the past year by 29%.

Economic Down Cycles and Initial Public Offerings

The NVCA and Thomson Reuters have found the current venture-backed IPO market is at its lowest levels since 2003. Venture-backed IPO's slowed dramatically in the first quarter of 2008. Over this time period, there were only five venture-backed offerings totaling $282.7 million in proceeds, a substantial decrease from the $1.9 B raised in the first quarter of 2007. The average offer amount in the first quarter of 2008 was much less than 2007. In fact, a number of investment banks anecdotally have reported a recent pause in IPO activity for information technology companies.





Source: Deutsche Bank

Current Q1 2008 data released by Deutsche Bank shows that the technology IPO market and stock price valuations have decreased sharply in recent months. Currently no tech companies are "on the road" and the premium on liquidity implies a bigger discount for IPO's if and when they will go public.

Solutions

The Private Equity Secondary Market: A Third Exit Option

In sum, today's sophisticated and challenging investment landscape creates an advantage for investors that utilize the secondary market to generate liquidity. Secondary funds provide investors with a variety of flexible exit alternatives in addition to those found in the M&A and IPO marketplaces. These options typically benefit both Limited and General Partners. Because each situation is unique, secondary funds work with sellers to create a solution tailored to their liquidity needs. Since Limited or General Partners also have the responsibility to maximize the value of their investments, utilizing the secondary venture market enables Limited and General Partners to improve fund performance and overall returns.

Who Are Secondary Market Sellers, and Why Do They Sell?

Sellers have historically been individuals and institutions who sold under distressed circumstances. However, as the market has evolved and grown, sellers have begun to use secondary sales as a portfolio management tool or to obtain liquidity at various times in the investment cycle. Any equity holder in a private company should consider the advantages of the secondary market, as it enables an investor to utilize a diversified investment strategy. For instance, some investors looking for higher returns will place money in higher risk alternative assets. If their risk appetites or circumstances change over time, investors can consider reallocating their investment portfolio and selling non-core investments in the secondary market. Many secondary funds specialize in these types of transactions and have years of experience assisting their clients.

Sellers of secondary investments include:

- General Partners
- Institutional investors
- Financial institutions
- Family offices
- Company founders
- Angel investors
- Pension funds
- Endowments
- Hedge funds
- Corporations
- Venture debt funds
- Management team members

Benefits for Limited Partners

Limited Partners historically have had a range of investment options from which to select within the private equity asset class: buyout funds, fund of funds, hedge funds, industry-specific funds, capital-specific funds, etc. However, Limited Partners assume risk when investing in this asset class, especially when considering that today's volatile stock markets and the global economic environment can influence exit options and exit values for their investments. Furthermore, not all funds will achieve a favorable internal rate of return (IRR) or multiple on invested capital. The secondary market can provide limited partners with a range of creative solutions to cull underperforming partnerships or lock in gains from a performing investment. These solutions allow investors to:

- Achieve full or partial liquidity to generate cash
- Access cash fixed in highly illiquid assets with a structured investment product
- Eliminate or reduce liability from further follow-on capital requirements
- Reallocate and re-tool portfolio strategy to improve future performance
- Exit all unnecessary and underperforming private equity investments

- Eliminate non-strategic investments or side-pocket funds
- Lock-in gains from a high quality and performing investment
- Remain current with regulatory obligations
- Generate tax gains and losses

Benefits for General Partners

As mentioned above, General Partners increasingly access the secondary venture market for a variety of reasons and sell both strong and weaker performing investments. Many different scenarios exist under which General Partners seek a secondary market liquidity solution. For example, some investors use the secondary market to sell a "tail-end" of an existing partnership that has reached the end of its ten year term. In addition, early stage investors generally use the secondary market to sell investments (or a portion of their investments) at a multiple of cost, thereby locking in investment gains and obtaining the ability to recycle capital. Also, General Partners who have structured their fund with an SBIC license (typically a 2:1 debt to equity ratio), use the secondary market to decrease or remove leverage on the fund. Altogether, the secondary market allows General Partners to:

- Achieve liquidity and generate cash and realized gains
- Hand-select LPs by partnering with those who provide follow-on capital
- Wind down an older vintage fund
- Remove or reduce leverage on their fund
- Refocus time and energy on newer vintage partnerships and investment areas
- Exit non-performing or strong-performing investments to lock in losses or gains

What Kind of Assets do Secondary Funds Buy?

Secondary funds have emerged in every segment of the private equity market during the last 10 years. Some secondary funds have specific investment criteria or focus on a market segment. Others are generalists and look at all types of secondary investments. For example, certain funds only invest in limited partnership interests in buyout funds in North America between $100M – 500M in size. It is important to understand the advantages of working with sector-specific secondary funds, as many funds focus on specific transactions, such as:

- Limited partnerships interests
- Direct equity positions in private companies
- Portfolios of venture-backed companies
- Older vintage funds

- Venture debt funds and warrant portfolios
- Founder and management team shares
- Stock options to help employees exercise their positions
- Special situation investments

Conclusion

Today, the venture capital market faces a tremendous imbalance between the number of funded companies and those companies who have achieved an exit through the IPO or M&A markets. Figure 1 illustrates that 89% of U.S. companies financed by venture capital firms during the period 2001-2007 remain illiquid, and it seems unlikely that the ratio will shift significantly. This imbalance creates strain for all types of investors—from General Partners to Limited Partners and even founding management teams. In order to reduce the unmet demand for liquidity, secondary funds have emerged to support the aftermarket and keep the venture capital industry viable and healthy. Secondary funds serve an important purpose by helping to enhance market stability during times of economic uncertainty. These funds have the ability to structure unique solutions to meet investors' needs; these solutions include but are not limited to the purchase of LP interests, direct portfolio companies, or "strips" of portfolio companies. Due to their experience and specialization, secondary funds know how to assess quickly potential investments and offer tailored investments solutions. Moreover, these funds offer an attractive exit option which is not only compelling in down economic cycles but also during periods of economic expansion.

Industry Ventures is a leading secondary fund focused on acquiring venture portfolios, limited partnership interests, and direct investments. The firm manages six funds representing over $400 million of invested capital and over seventy secondary investments. The team works closely with sellers to achieve their objectives and provide a liquidity event. For more information on how Industry Ventures can help provide a liquidity solution right for you, please visit www.industryventures.com.

Hans Swildens
Industry Ventures, Principal and Founder
Expertise: Secondary direct transactions, venture fund buyouts, limited partnership interests, fund of funds buyouts, venture capital investments, recapitalizations, founders stock purchases, and special situations.

For the last twelve years, Mr. Swildens has worked in Silicon Valley as an entrepreneur and venture capital investor. This includes starting and managing his own software company (Microline Software – acquired by Blaze Software) and acting as a value added board member and consultant to the founders and CEO of Speedera Networks (acquired by Akamai), nCircle Network Security, StepUp Commerce (acquired by Intuit), Discovery Mining, etc. Most recently Mr. Swildens founded Industry Ventures, a leading secondary fund that currently holds investments in over

75 companies and 40 venture capital funds. Some of the notable realized investments include Cambridge Display (acquired by Sumitomo), Trados (acquired by SDL), Watchfire (acquired by IBM), and Rendition Networks (acquired by Opsware).

Appendix

In order to give potential investors more insight into secondary funds, we have included a summary of the typical investment process, along with two case studies.

The Typical Investment Process

When engaging a secondary market firm, sellers should understand the typical sale process. The process to sell private investments typically involves the following steps:

Review & Qualification. Upon an initial consultation, a buyer will determine if the investment meets his qualifications. Using internal tools including proprietary databases and models, a secondary fund should quickly and fairly value an investment. Depending on the complexity of the underlying assets and structure, this process can generally be completed within a few days.

Initial Due Diligence. Once the seller has agreed to move forward, a secondary fund will perform in-depth due diligence on the underlying assets in the portfolio. This process, which can take between one to four weeks, typically involves reviewing fund documents, current financial reports, and business and securities documentation. Other items to consider are voting rights, rights of first refusal (ROFRs), escrow agreements, transfer provisions, and other legal and tax implications.

Letter of Intent and Final Due Diligence. Upon completion of an initial due diligence phase, secondary funds provide the sellers with a Letter of Intent (LOI). If the pricing and terms are acceptable, the buyer and seller move forward with a purchase agreement. The offer usually contains final business and legal due diligence contingencies.

Purchase Agreement. After the LOI is signed, the secondary fund sends the seller a standard purchase and sale agreement. Once both parties have signed a purchase agreement, the secondary fund prepares all the necessary transfer documentation, including obtaining consent from each General Partner, if necessary.

Closing. The Closing is consummated when all legal documentation for investment transfer is complete; money is then exchanged.

Case Studies

Limited Partnership Interest Secondary

A general partner from within Industry Ventures' network referred the team to a family office based in the southeast United States in late 2007. During initial conversations with the director of alternative asset investments, it became clear that the family office was burdened with tax needs that created a unique value proposition for selling a number if its limited partnership interests in venture capital funds.

Because Industry Ventures was already an investor in two of the three firms in which the seller wanted to divest, the team was able to run an effective diligence process and assure the seller of an efficient transaction. Within a very short period of time, Industry Ventures proposed a price to assume the seller's limited partnership interest in three California-based funds, including the seller's unfunded commitments to these partnerships. Within 90 days, Industry Ventures had closed the transaction with the seller and wired the proceeds.

At the completion of this transaction, the representative from the family office stated, "…I am very happy with how this process unfolded. I truly hope this is a good deal for Industry Ventures, as I am quite pleased with our end of the transaction." Gaining liquidity on these typically illiquid assets was not only an excellent monetization strategy, but the family office's clients also received substantial tax benefits from the transaction. Since the close of this deal, Industry Ventures has been engaged in discussions with all three of the general partnerships, helping to institutionalize their limited partner base. Industry has also made introductions to other potential limited partners for their future funds.

Direct Investment Secondary

In late 2006, Industry Ventures began tracking the performance of a Bay Area-based software company that served a segment of the financial services industry. The company had been in existence for over eight years, and as the capital markets depressed in 2007, some of the firms that backed the company in its early years began to experience "investor fatigue."

Almost a year later, Industry Ventures made an offer to purchase a number of shares in the company, and with board consent, executed an investment in the company. A number of early shareholders tendered their shares, and Industry Ventures acquired a meaningful position in the company. Ravi Chirulovu, a venture capital investor in the company notes, "Industry Ventures ran a very professional process, and provided a meaningful service for a group of investors who have been committed to this company's success for the larger part of a decade. Since making the investment, they have been very engaged with the management team and have been a value-added board participant. They are clearly committed to helping the company grow." The liquidity provided by Industry Ventures gave the management team and its investors a longer runway, allowing the company to execute against its vision and obtain future capital support. Industry Ventures' involvement improves the probability of creating an optimal liquidity event for all shareholders.