Portfolio For Sale

Selling a portfolio of startup investments was once considered anathema. But the reasons to take such a step are multiplying and it's slowly becoming an accepted practice. Here's what you need to know ... just in case.

By Matthew Sheahan, Senior Editor

It said "CONFIDENTIAL" right at the top of the page. But that didn't stop someone from sending the file to the *San Jose Mercury News*, which promptly posted it on its website for the world to see.

It was a sales agreement from Angel Investors. The famed Silicon Valley angel group has been winding down its second and final portfolio and it made a deal to sell its remaining stakes in various startups to Credit Suisse First Boston.

The document, which you can find at www.siliconbeat.com, provides a glimpse into the relatively new (and somewhat secretive) practice of VCs selling portfolios on the secondary market. Just as LPs overcame any sense of shame in selling their holdings in venture funds, venture investors are starting to accept the secondary market as another tool to manage their portfolios.

The secondary market for venture portfolios was virtually nonexistent five years ago, with a mere $8 million in deal volume, according to Lexington Partners, which tracks secondary market data. But last year the total reached $350 million, Lexington says. Although the number has increased, it's still a fraction of the market for secondary LP interests, which totaled $7 billion last year, according to Lexington.

Some maintain that the market for so-called "direct venture portfolios" could grow to billions of dollars annually, and a number of shops have sprung up to handle the deals *(see Buyers Guide, page 29)*. Others say too many buyers are already bidding

on assets and that a shakeout is inevitable.

"It really is an emerging area of the secondary market," says Michael Hoffman, president and founder of advisory firm and placement agent Probitas Partners, which advised W Capital Partners, a New York firm that specializes in buying venture portfolios in raising a fund to purchase venture portfolios. "There are a lot of people revving up to play there."

"In 2002 we had a hard time convincing people that [selling their venture portfolio] was the right thing to do," notes Kenneth Sawyer, managing director with San Francisco-based Saints Capital, which buys venture portfolios. Sawyer estimates that if the secondary LP business is a $20 billion available over four years, the venture portfolio portion should be 10% of that, which comes to $2 billion. "Our pipeline continues to grow because people are becoming more comfortable with the fact that there is a market for direct secondary sales."

Buying venture portfolios is essentially a much different business than the traditional secondary market of buying LP interests. It is more of an extension of the venture capital industry than the secondary LP industry. "As an LP we live a little vicariously," says Jerry Newman, president of New York-based Willowridge. "[Direct buyers] actually get down and interact with all these companies. Theirs is an extension of the direct investment business." Willowridge has worked closely with two such firms, Saints Capital and Industry Ventures.

Who's Selling and Why

Corporations and large financial institutions continue to be the biggest sellers of venture portfolios. But venture portfolio buyers expect to see more traditional venture capital firms putting assets on the market, and they see business from traditional VC funds as being a major driver of market growth over the next few years. One secondary buyer says that traditional VC portfolios might even comprise as much as 50% of his firm's business within a year.

VCs usually sell for one of three reasons:

- They want to focus more energy on their current investments by selling their stakes in portfolio companies in funds that have long since stopped investing. The companies may still show promise but have drained time and money without showing a return after many years. These deals are called "tail ends."
- They have an unsuccessful first-time fund that's out of money and they feel obliged to hand off their portfolio companies to someone who can provide capital for follow-on rounds.
- They are either undergoing a strategic realignment and will no longer have the capacity to manage investments of a certain size or sector, or they are winding down the firm after unsuccessfully seeking another fund.

Some see GPs in traditional venture firms are warming to the idea of selling parts of their portfolios. "There are very substantial GPs that understand the benefits of it and are using it," says David Wachter of W Capital Partners.

Bryon Sheets, a partner with Paul Capital Partners, a San Francisco-based traditional secondary firm, sees GPs entertaining the idea so long as their performance in later funds is good. "GPs feel more comfortable doing these deals if they have performance comfort," Sheets says. "If they're investing a fund VIII, and a fund III has two or three assets to sell, they feel they can go back and sell those assets in a secondary sale without

being second guessed." Sheets cautions though that if a company has still not exited a fund after nine or 10 years, you have to ask why.

For now, venture portfolios account for a small part of the assets being purchased by secondary firms. For example, of the 14 portfolios that W Capital has closed on, four were sold by traditional VCs. Three of these were from foreign sellers Wachter sees traditional VCs as on the same path to greater acceptance of secondaries that their corporate counterparts have already traveled. "It's following the same exact pattern of corporates or financial institutions in the 2000-2002 time frame, which migrated to a tool that's now used by corporations and banks to exit non-strategic investments or modify a business strategy," he says.

Traditional VC firms typically sell what are called tail ends, companies remaining in funds that have long since quit investing. These portfolios, from funds usually 10 years older or more, may have stronger companies in them than what comes from the larger volume of corporate and financial institutional sellers. After all, these are companies that have survived a long time.

Dollar amounts =estimated purchase price + projected un-funded commitments.
Source: Lexington Partners

"One thing that's changed over the last year is that there are a large number of tail-end opportunities," says Hans Swildens, a managing director at Industry Ventures of San Francisco. Tail ends from traditional VC firms comprise a "big chunk" of Industry Venture's deal flow.

Industry Ventures purchased some tail-end venture investments from Bowman Capital in late 2003 after Bowman bailed out of private equity investment. More recently, Waltham, Mass.-based Atlas Ventures last year sold a portfolio of six companies to the Omega Fund, a secondary fund managed by Geneva-based Omega Advisors. It was one of the first transactions in which a combination of public and private assets have been sold by a traditional VC firm from its legacy funds, according to Atlas.

Jean-Francois Formela, a senior partner with Atlas, says there was no pressure from Altas's limited partners to sell the assets; the firm was approached by several potential buyers looking for opportunities. Atlas sold some old deals from old funds in what Atlas treated as a kind of housekeeping. While Atlas isn't considering any similar sales currently, it would consider such a deal in the future. "The secondary market does its job," Formela says. "We can say, 'Yes, it works, and it's a good idea when it's needed.'"

Some other VCs that haven't sold portfolios on the secondary market say they aren't opposed to the idea, even if they aren't warm to it. "We feel it's our responsibility to manage our funds to conclusion," says John Martinson, a managing partner with Edison Venture Fund of Lawrenceville, N.J. Edison has not sold any of its assets on the venture portfolio secondary market. Martinson says his motivation for selling a theoretical portfolio would be to satisfy the desire of his LPs to finish a fund. "We understand that there are time frames to be mindful of, so we would consider that," he says. A fund would have to go beyond the normal extension period of 12-13 years in age to be a candidate for sale, he adds.

Poised for Growth

Investment trends within the venture capital industry point to potential growth in sales of venture portfolios, says Colin Blaydon, a professor who tracks private equity for the Tuck School of Business Administration at Dartmouth College. For example, some venture firms have gravitated to less risky later-stage rounds, a type of investing that can be more capital intensive than early stage investing. Those VCs moved into this segment thinking that exits were right around the corner, but they didn't materialize and now portfolio companies need money that their VC backers may not be prepared to invest.

"For the last two years the perceived sweet spot has been growth to late-stage venture," Blaydon says. "If you have an opportunity to take a late-stage investment off

the hands off someone who doesn't want to continue to fund the needs of the company to get it to a successful exit, there area lot of people out there who find that attractive."

What may be a new development is the presence of funds that are not tail ends: portfolios of funds that are between five to seven years old or maybe younger in some cases.

Venture portfolio buyers point to the large number of venture funds raised in the 1999-2000 time frame that are starting to mature. Not all the firms that began investing five years ago are going to be able to raise another fund, and this may push a large number of portfolios onto the secondary market as general partners from lame duck venture firms look to move on. "You've had a huge swelling of capital in the venture industry in the past 10 years, particularly in the last five years," says Gretchen Knoell, a partner with Lake Street Capital. "A lot of people aren't going to be able to raise another fund and they're going to need to shift gears and resolve things."

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>
> *Anonymous venture portfolio seller*

Harbert Mulherin, a managing partner with Dallas-based secondary buyer Live Oak Capital, agrees. "A lot of the funds—I call them the shake-and-bake funds around the Internet boom—were not as prudent with their money," Mulherin says. He has looked at several venture portfolios brought to him but so far has not done any deals in the segment. He sees assets being offered by groups that have logical reasons to sell off their portfolios. "They have situations where they're out of money. Firms are out of money with positions in companies that need more money and they're going to get crammed down."

This segment of the market is still hushed. "The GPs don't want people to know they're having these conversations," says Industry Ventures' Swildens. "They're going to be looking for a new job or raising a new fund under a different name." He adds that two years ago this was not the case. He predicts that the secondary market for portfolios from those funds will grow substantially over the next three years.

Another factor influencing the sale of portfolios is pressure from limited partners. LPs "want to end the life of the fund; they want to get the fund wrapped up. They don't want to pay more management fees if they're not making money on it," says Knoell of Lake Street.

Christopher Kojima, a managing director with Goldman Sachs and co-head of its Private Equity Group, says various kinds of institutions with venture capital portfolios face "serious resource constraints in monitoring and reporting" that may push them to get rid of some of their assets. "Particularly in portfolios of directs when you need to make serious decisions about follow-on rounds and need to have an active role on boards," he says. "The market is opening up with more than just the traditional sellers exploring the possibilities."

One Seller's Story

A venture capital professional who spoke with *VCJ* on the condition that neither his nor his firm's name be used agreed to describe how he went about selling a venture portfolio of more than a dozen companies. The seller oversaw a venture capital program for a large company. "We did not have a mandate to get rid of this at any price," he says. "We had the go-ahead to find out what the market thought that our portfolio was worth and compare it to what we were willing to hold it for, taking into account the cost of managing assets that were no longer in our strategic basket." The seller says that his group, which had never sold a venture capital portfolio before, was very careful, conservative and deliberate in its process.

He began searching for a buyer by contacting about seven secondary firms. Of those seven firms, six signed non-disclosure agreements to pursue a secondary buy and five submitted bids for the venture portfolio. The seller chose three of the five bidders as finalists to do more detailed due diligence.

"The big-name firms, those that obviously had experience, were a pleasure to deal with. The newcomers showed their inexperience and that made them less attractive candidates," said the seller, who ultimately sold the portfolio to W Capital Partners.

The seller called each company individually and followed up with a formal letter explaining the sale. "We wanted to respect the management teams in our portfo-

lio companies and not create problems in any way by sending a signal to the market that we were unhappy with them at all, so we purposefully kept this very quiet," he says.

The majority of the companies and co-investors in his portfolio were helpful, with some even taking an active role in helping the seller put information together for potential buyers. Others were not helpful and remained unwilling to disclose any information to potential secondary buyers. When he appealed to some of his co-investors in those companies, he also met with resistance. "We asked for their permission to distribute information. Some of the companies went so far as to correct things for us and helped out a tremendous amount. Others basically said 'I won't stand in your way; you have what you have.'"

The seller said he has learned to dislike right-of-first-refusal clauses as well as co-sale and tag-along clauses, because they restrict an investor's ability to sell assets on the secondary market. "What seemed to be a good idea when you were crafting the investment didn't seem like a good idea when you were getting ready to exit," he says. He says that the entire process took longer than he expected but not longer than the secondary groups involved expected, and that finding a law firm that had done these kinds of secondary deals before was "worth the search."

The entire process started with the decision to go to market. Preparation, market testing and research took up the first month. Two months were dedicated to assembling bidders, signing NDA agreements and distributing initial information about the portfolio. A month-and-a-half later the seller had whittled the initial bids down to some finalists. After another month and a half of negotiations, the deal was done. Overall the process took six months. "If I had another portfolio to do, I think I could do it in four," the seller says. He declined to reveal the size of the discount he accepted to sell the assets.

GP Resistance

Even with the increase in sales of venture portfolios, many traditional venture capitalists say they don't see the secondary market as a viable tool for portfolio management. They feel they're obliged to see their portfolio companies through to the end. Guy Nohra, a director with Alta Partners in San Francisco, says the concept "sounds intriguing, but we're probably so loyal to our portfolio I just don't know how we would ever do something like that."

It's the same over at Partech International, a traditional venture firm in San Francisco. "I understand why people would do it, but it seems counter to the idea of a long-term partnership," says Dave Welsh, a GP at Partech. He notes that his firm has found success with some portfolio companies "beyond the typical range of what is normally considered in a venture fund."

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InterWest Partners of Menlo Park, Calif., has sold some shares in individual companies to co-investors or to the companies themselves, but it has never sold a portfolio or group of holdings to a third party. "If we have a number of companies still alive in a portfolio at any one time we feel it's our job to manage those companies to fruition," says InterWest GP Stephen Bowsher. "If you're down to one or two investments in a portfolio then it might come down to that kind of decision." He says he would not entertain a portfolio sale and doesn't foresee selling any individual company interests on the secondary market.

Not So Bullish

Not everyone is convinced that the market for venture portfolios will explode. Some predict that much of the potential capital will never reach the marketplace due to sellers getting cold feet, and those that have crowded the marketplace may end up competitively bidding themselves out of business by paying too much for assets.

"We're not great fans of this market anymore," says Frank Neale, a founding partner of London-based secondary buyer IRRfc. Neale founded IRRfc (previously known as Phildrew Ventures) in 1985 and ran five private equity funds before selling the business to UBS in 1998. Four years later, he bought back the assets from UBS and

had a new mandate: manage direct portfolios. The firm's first contract was to manage a portfolio of assets for UBS worth approximately $375 million.

IRRfc had so much trouble trying to get deals done that it has given up on the business and plans to disband once it manages its current assets to liquidity. "We've been knocking on doors for the better part of 18 months to two years," Neale says. "We're tired of knocking on doors and wearing out shoe leather for a market we don't think is substantial." He adds that his firm has talked to all manner of potential sellers and many of the portfolios he's seen have been of "dubious quality."

While most potential deals fell apart due to disagreement over prices, many assets never got to pricing negotiations at all, as many potential sellers decide not to sell due to "loss of face," or fear that they will look bad in the eyes of their investors for not managing their assets through to liquidity. Sellers "would rather hide the problem for a bit longer and hope it comes good in the end," Neale says. "You get silly comments like, 'These things will look after themselves.' They won't, particularly on the venture end."

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Frank Neale
Founding Partner, IRRfc

Another factor working against third parties is incumbent portfolio managers. Coller Capital has been active in buying private equity portfolios and then spinning out the management team as an independent entity, with Coller as the sole limited partner. While these groups are first obligated to manage the assets that the larger buyer purchased, they are free to raise their own capital and continue to buy and manage other assets on their own once their portfolio is finished. Groups that Coller Capital started in this way include New Venture Partners, which spun out of Lucent Technologies, and Multiple Capital, which spun out of Innovatech Montréal.

"Most of the banks with a decent size portfolio have gone to incumbent management teams and there's no role for third parties like us," Neale says. "If an incumbent management team is even half decent they'll win it. No matter how badly [the management team has performed, the sellers] prefer someone who knows the assets as opposed to someone who doesn't."

Christy Richardson, co-manager of the Secondary Fund for Thomas Weisel, says that her firm's pipeline of deals has seen a shift in favor of limited partner secondary interests. She says her deals were split 60/40 in favor of LP interests in 2003, but the ratio has gone to 75/25 in favor of LP interests. "We saw more proactive selling on the part of corporations and financial institutions in the '02 to '03 time frame," she says. "This is a relevant and important segment of the market, but we're also seeing perhaps too many groups coming together." She says that there is "definitely a need" for a shakeout among direct secondary buyers.

Ian Charles, vice president of secondary private equity advisory firm Cogent Partners, says that not only are there too many secondary buyers in the venture portfolio space, they are at a disadvantage by the very nature of what they do. Charles says that secondary buyers do not have the same kind of relationship with the management teams of portfolio companies that primary investors do, and that makes it harder for them to create value as an investor in those companies. Secondary investing "has the same risk profile of a venture capital fund, but it doesn't come with the role as a value creator that most venture capitalists are able to use," Charles says. "Some of [the secondary venture portfolio groups] will go away. There aren't enough deals to support all of them."

While traditional venture capitalists may not ever publicly embrace the idea of selling portfolios on the secondary market, it makes sense that more of them would do so. As the secondary market matures and becomes institutional, sellers are showing up for a variety of reasons. Venture groups making their final exit can always turn to the secondary market, but traditional VCs are finding a place there as well.

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