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Running on Empty

Out of cash as they near the end of their road, struggling dot-com era funds are turning to secondary firms for a few extra gallons of gas

Last summer, a Silicon Valley venture firm was in dire straights. Its first and only fund, raised in 1999, was fully committed except for follow-on capital.

And though its three partners had been trying to raise a new fund since the beginning of 2005, the outlook was grim. The firm had several strong consumer startups in its portfolio, but with just one modest exit, its limited partners were less than enthusiastic about staking the team a second time.

Then a friend from another firm suggested that the managing partner sit down with **Hans Swildens**, founder of **Industry Ventures**, a secondary shop in San Francisco. At that meeting, Swildens proposed a way to keep the firm in the game: a fund add-on. Specifically, Industry Ventures, along with three other new investors, would give the firm $20 million in exchange for a 20% stake, based on its net asset value.

The firm's LPs would have to reach a consensus first, because the new capital would dilute their ownership positions, but assuming they approved, the money would support the firm's portfolio and provide the team with enough dry powder to make one or two new investments.

The firm, which asked not to be identified, said yes to the deal.

So have several other venture funds over the last 24 months, according to Swildens, who is among a growing number of investors offering creative financing that's so much in demand it's beginning to spread through the venture industry like a virus.

Fund add-ons are just the start. Venture firms are also selling partial stakes in their portfolio companies to secondary funds, selling to other venture firms by way of secondary transactions, and selling their funds lock, stock and barrel to secondary investors, which, occasionally, will allow them to continue managing the funds for reset economics. And that's not all. The best of the struggling firms are bargaining their way into a new pact called a stapled commitment.

That a whole lot of financial engineering is happening in the venture business right now isn't surprising. Venture funds deployed billions of dollars between 1998 and 2002. In 1999 alone, 96 new funds locked down $8.5 billion in capital, according to the **National Venture Capital Association**. That was a huge increase from five years earlier, when 22 new funds raised a combined $1.7 billion.

As those funds near the end of their 10-year investment periods, panic is setting in at the firms that haven't produced results necessary to raise new funds. A stunning 210 dot-com era venture firms haven't raised new funds since 2000, according to **Thomson Financial** (publisher of *VCJ*). "By last year, our commitments to a number of venture funds of those vintage years had already dragged out much longer than we cared for them to," says the head of alternative investments for a software company who asked not to be named.

Institutional investors aren't the only ones GPs are worried about. Roughly one-fifth of those older venture funds are also feeling squeezed because they accepted money from the **Small Business Administration**'s now-defunct Participating Security Program. Until it was suspended in 2005, the program provided twice what a venture fund raised from private limited partners in exchange for its money back plus a small amount of interest and 10% of a fund's returns. Now, many funds are finding they don't have enough money to make Uncle Sam whole. "A whole bunch of funds are being motivated by SBA dynamics to sell off a percentage of their ownership," says **Ken Sawyer**, founder of San Francisco-based secondary investor **Saints Capital**.

As more funds look for a way out of their troubled situations, secondary funding sources have mushroomed. Roughly 30 dedicated secondary private equity funds have sprung up over the last 10 years and their assets have grown in a straight line toward the sky. In 1998, they collectively raised $1.3 billion, but this year they'll raise nearly $19 billion, predicts **NYPPEX**, a private equity trading and banking firm that tracks the secondaries industry.

The venture piece of the overall picture is much smaller, but it's also ballooning. Saints Capital estimates that assets for secondary direct transactions in the venture industry stood at $1.25 billion in 2006 and will grow to roughly twice that amount by the end of this year. Saints, which closed on a $100 million fund in 2005, has raised more than $220 million for a new fund whose first close was in December. Similarly, Industry is closing its newest fund at $200 million, nearly as much as the $250 million it has raised overall via seven previous funds since its 2000 inception. **Lake Street Capital**, **Pantheon Ventures** and **Paul Capital** also have venture-oriented secondary funds that are seeing more action these days.

"With LP concerns about a recessionary environment that's expected to add approximately two years to exit dates, and lower IRRs, we're seeing a significant increase in LPs planning to sell venture fund interests this year," says **Larry Allen**, a managing member at NYPPEX.

Add-ons

Fund add-ons are one of the newest strategies for boxed-in venture funds, though it remains to be seen how popular they will become. For one thing, no one has proven that the strategy can actually help a troubled firm keep going in the long term. For example, **Dali Hook Partners**, which now goes by the name **Keynote Ventures**, raised a $40 million add-on in 2006 from **HarbourVest Partners** and others for a vintage 2001 fund, but it is unclear if it will be able to raise a new core fund. Co-founder **Paul Dali** remains at Keynote, but co-founder **David Hook** is now with **Baymark Partners**. Neither responded to requests for comment.

There's also a good chance that by attempting to do an add-on that a venture firm could alienate its LPs. The LPs of troubled firms don't want to think about re-upping to maintain their share of an old fund, and they don't really want to hear that their stake will be diluted if they don't. "It becomes another investment decision," says managing director **Michael Kelly** of institutional investor **Hamilton Lane**. "What does a new investor see that we don't? And are we leaving money on the table by leaving today? It complicates things."

"You definitely have to offer your existing LPs something—a rebate on management fees or some other kind of carrot," says the managing partner of the Silicon Valley firm that received a $20 million injection last year. "While savvy institutional investors might recognize the need [for the fund to raise more money], individual investors may not, so it takes a little bit of massaging to explain the transaction."

LPs might also see the infusions as self-serving, since, in some cases, the firm's general partners can receive carry on a fund that is in a loss position. Industry Ventures, for example, says that it will pay between 10% and 20% of its profit to a firm that returns 1.5x to 2x its investment.

Strip sales

VCs who can't get limited partner approval for an add-on—or who don't even want to broach the subject with their LPs—are taking a route that doesn't require LP approval: the strip sale, wherein a GP sells a stake in a portfolio company. Though most startups have the right of first refusal—meaning they can buy back their own shares if they don't want them changing hands in the marketplace—GPs can sell their shares "as they see fit," says **Cliff Meijer**, a managing director of **Thomas Weisel Global Growth Partners**, a private equity fund of funds that has made secondary investments.

Strip sales aren't new, but they are happening more frequently, says Sawyer. "Sequoia sold shares in Apple before it went public," he says. "But in today's market, people are much more comfortable [with strip sales]." It's a little like how the buyout world evolved, he adds. "Ten years ago, you couldn't say, 'I'm selling my buyout investment to another buyout firm,' but now it happens 50% of the time."

In the past two years, Thomas Weisel has invested roughly $30 million in a variety of strip sales across seven venture firms, Meijer says. In one case, it bought small positions in all of the companies in a venture fund's portfolio.

Thomas Weisel also bought one fund's entire stake in a startup, a type of transaction that San Francisco secondary shop Lake Street is doing a lot of these days. "I'd say such sales account for about 70% of the deals we're looking at vs. three years ago when you didn't see these events," says **Gretchen Knoell**, Lake Street's co-founder.

Knoell, who declined to discuss the number of transactions Lake Street has done, says her clients' biggest problem is trying to invest new funds while saddled with older funds whose companies have no good place to go. For a discount, she's happy to take those companies off their hands. If Lake Street "buys into those startups and starts the clock over at pricing that make sense to us, we can make a good return," she says. "We might be happy if someone pays $15 million for a company, whereas the venture firm would need to see in excess of $100 million."

In some cases, secondary shops are willing to pay a premium to get a stake in a portfolio company. **David Wachter**, founder of secondary shop **W Capital Partners** in New York, says he recently discovered a startup that first received venture backing in 2001. The company is doing well, but its venture backers were willing to consider a secondary sale because they wanted to turn their attention to newer investments. Wachter is convinced the startup will be a "home run," so he agreed to pay 10 times the current value of its shares for half the venture firm's stake. (Like most of the other firms in this story, Wachter declined to name the VC firm involved in the transaction or give further details.)

Brian Jacobs, co-founder **Emergence Capital Partners**, which makes early and growth stage venture investments, says Emergence has twice bought startup shares through secondary transactions. In both cases, the sellers booked a profit, he says.

Of the firm's most recent purchase—which it made through Industry Ventures—Jacobs says: "Part of the rationale for the [selling] venture fund was that they are raising a new fund and the company had appreciated, but there'd been no write up in the portfolio because there'd been no transaction. By selling, they could give their LPs liquidity and mark up their position."

While partial sales may give a venture firm some breathing room, they are unlikely to be enough to convince investors to come back for another fund unless they produce big returns. Says Kelly of Hamilton Lane: "We're happy to get money back [from a strip sale], assuming it's at a good valuation, but does it then tell me that this VC has demonstrated they can get exits? Not unless they've returned some multiple of cost."

Recapitalizations

Firms at the end of their investment periods have yet another option they may not know about: a recapitalization. With approval from LPs, a firm can sell its entire fund to a secondary shop, which sometimes will rehire the firm to manage the portfolio with reset management fees and carried interest.

Thomas Weisel alone has done half a dozen such deals so far, including recapitalizing **Garage Technology Ventures** in 2006 along with **Draper Fisher Jurvetson**, **Silicon Valley Bank**, **E*Trade** and other investors. In a press release at the time, Garage positioned the recapitalized fund as a "complement" to an earlier fund that it had raised in 2002 from lead investor CalPERS. Managing director **Bill Reichert** of Garage, explains that Weisel helped Garage convert from a C corporation into an LP entity, an experience he calls "interesting" and "complex." He also says that Thomas Weisel was "extraordinarily helpful and useful in helping us get this done."

Meijier wouldn't disclose the other funds Thomas Weisel has recapitalized, citing confidentiality agreements (Garage made its own arrangement public), but he says they are "primarily" funds that make early and to mid-stage investments in technology, such as Internet, communications and hardware companies.

While a recapitalization may look attractive, a firm should seek approval from its LPs before pursuing such a transaction, even if the partnership has the discretion to sell its assets without such approval, advises Meijier. "It might look like a great opportunity [for a venture firm]," he says. "They get new economic terms, a new carried-interest provision, and we might give the portfolio a little additional capital for portfolio financings. But the VCs' primary responsibility is to find the best deal for their existing investors."

Aaron Alter, a corporate securities partner at **Wilson Sonsini Goodrich & Rosati**, has another piece of advice for venture firms considering a recapitalization. Before signaling an interest in selling the portfolio, ensure the startups whose shares will be sold are amenable. "You can't transfer those stakes without the consent of the company [which would have the right of first refusal], so you want to make sure they aren't going to stand in the way, especially if it's one of the jewels in the portfolio that the secondary purchaser is really after."

If you have consents ready to go at the beginning of the process, says Alter, "secondary funds can move very quickly. I see some signing deals as fast as two to three weeks." Meanwhile, issuers who aren't motivated to transfer the ownership stakes can drag out the process for many months.

Stapled secondaries

Some say that a "pure" secondary player is the last place a venture firm that wants to raise a new fund should turn. "If you're a GP, what you don't want to do is sell to a shop that is just going to buy the assets you're selling," says **Kelly DePonte**, a managing partner at placement agency **Probitas Partners** in San Francisco. "They'll be doing your LPs a favor, but they aren't set up to invest in your fund."

DePonte says a better approach is to pursue a so-called stapled secondary, in which an investor is allowed to buy a firm's existing LP stakes at a discount in return for committing capital to a firm's new fund.

Summerhill Venture Partners, which spun off from Bell Canada last summer, is one recent example of how a stapled secondary works. When Canada's largest telephone company abruptly decided to scale way down on its venture exposure, Summerhill (formerly known as **BCE Capital**) needed new LPs if it wanted to stay in business. It went to Probitas, which connected it with potential LPs such as fund of funds Paul Capital, secondary player **Credit Suisse Strategic Partners**, fund of funds **Montagu Newhall** and telecommunications company **Nortel**.

Some of those LPs bought out Bell Canada's $60 million stake in Summerhill and put up another $115 million to effectively create a new $175 million fund that could make follow-on investments in companies in the prior fund as well as new investments. None of the parties involved would disclose the discount price they paid for Bell Canada's stake.

Such transactions aren't ideal for commitment-phobic LPs, who for every $2 they put to work in a secondary sale are legally bound to invest $1 in the next fund. "Generally, we don't like stapled secondaries" says **Lisa Edgar** a managing director at Paul Capital.

They are happening nevertheless. "We've already seen twice as many this year than last year, and the year before they were nonexistent," says Edgar. Hamilton Lane's Kelly says he has seen the same trend.

Edgar declined to say whether Paul Capital participated in the stapled commitment for Summerhill, but she says her firm is willing to do them for the right GPs. "We'll only do them because we can buy the assets at a secondary price, and we like the manager and we're interested in committing to the next fund anyway," she notes.

Indeed, Edgar says that Paul Capital is currently considering a stapled commitment and that "two are three are in our deal log."

Just how many venture firms succeed in pulling them off remains to be seen. Summerhill was in a relatively unique circumstance. By and large, Edgar observes, "the ones who are trying it aren't the name brands, and they're having some difficulty." Indeed, Alter of Wilson Sonsini says that one of his venture firm clients "recently tried to put one of those together and couldn't."

Seller beware

One GP who went through the secondary process advises others to be "cautious of which [secondary] firm you use." The GP, who asked not be named, is unhappy with his experience with Industry Ventures. According to the GP, his firm, which was liquidating three publicly traded funds, hired the New York investment bank **Burnham Financial Group** to canvas secondary shops, several of which bid on the portfolio. Industry Ventures, working in concert with the East Coast secondary shop **Landmark Partners**, offered the GP the most attractive terms for the majority of those assets.

The GP says that though the Industry Ventures' letter of intent explicitly stated which assets it would purchase, and that those assets would continue to be managed by one of the GP's partners, "it became apparent that Hans [Swildens] didn't want to honor that deal."

Private equity attorney **Carl Metzger** says GPs shouldn't assume that everything in a letter of intent will come off as expected. "A letter of intent is often taken as what it says it is, a letter of intent rather than a binding agreement," says Metzger, a partner in the Boston office of law firm **Goodwin Procter**. "Often, they have enough escape hatches built into them that they don't constitute more than that."

The agreements are typically honored, however, just as term sheets tend to be, because the venture industry is a relationship business. Not in this case, says the aggrieved GP, who claims Industry Ventures decided to purchase fewer assets and to manage them internally. Because the venture firm had already turned down other bidders and was reluctant to go back to the market, it felt compelled to move forward, the GP says.

The deal that was ultimately struck wasn't good for the companies whose shares were sold, says the GP. "What those startups wanted as part of the deal was the knowledge that someone was going to be working to bring out their value, and the relationships we had with their directors and other investors would have been important toward that end." Industry Ventures' handling has "already resulted in the early disaster of one of those companies," he says. "They've managed to bring down the valuation of another from what was around $30 million to $3 million, and they've severely annoyed some of the other investors, who've essentially told them to pound sand."

For his part, Swildens says that Industry and Landmark ultimately chose not to allow one of the venture firm's partners to manage the assets because Industry and Landmark "felt uncomfortable with some of the legal risks around the SEC's requests surrounding the partnership's liquidation."

With regard to the assets that were discussed and not purchased, Swildens says it was one asset, an online gun and ammunition retailer. "Initially we didn't think it would be a problem, because the company looked like it was going out of business." In fact, it later reorganized under Chapter 11. But because it was an ongoing entity at the time of the sale, Landmark had to pass on it as its mandate prohibits buying any type of arms company, Swildens says.

In the end, no one really knows how secondary sales will impact the many firms in dire need of an eleventh-hour solution. Edgar says of stapled commitments, "Because they're taking place in real time, it's hard to know how successful they'll be." The same could be said of fund add-ons, strip sales and recapitalizations.

No doubt there are some gems in those aging portfolios, companies that have survived a downturn, layoffs, regulatory changes and worse. But are there enough of them, and are secondary sales the answer for GPs hoping to stay in the business of venture capital?

Maybe, but it's a long shot. "You can point to lousy market circumstances, but many of them had no business being GPs in the first place," says DePonte. "Those who did have either raised new funds or quit and have been hired elsewhere. There's nothing in the others' track records that suggests that they know what they are doing."

"Throw these firms a lifeline?" he says. "I'm more of a mind to shoot the wounded."

Source: VCJ reporting and Thomson Financial

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