

## Markets: New stock on the block

By David Gelles

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Talk-show host Oprah Winfrey, second from left, with Chris Christie, New Jersey governor, left, Cory Booker, mayor of Newark, New Jersey, second from right, and Mark Zuckerberg, founder of Facebook, during a live broadcast of 'The Oprah Winfrey Show' in September in Chicago. Mr Zuckerberg has pledged to set up a foundation to donate \$100m to Newark's schools over the next five years

One Friday last month, Mark Zuckerberg appeared on *The Oprah Winfrey Show* to announce a \$100m donation to the troubled school district of Newark, New Jersey. The gift was remarkable, especially coming from a 26-year-old who walks to work from his modest home in Palo Alto, California.

But the Facebook chief executive, [estimated by Forbes magazine to be worth \\$6.9bn](#), is a billionaire only on paper. The social networking company is privately held and is said not to be going public until at least 2012. So instead of cash, the donation will entail the transfer of \$100m worth of stock in his company to Startup:Education, a foundation established to manage the gift. To convert the shares into cash, it will sell them on the booming new market for stock in private US companies.

Companies are staying private longer than before, which delays big paydays for early employees and investors. Yet some are quickly reaching profitability, outpacing the growth of many public companies. Now, institutional investors impatient with the poor performance of public markets are looking to this multibillion dollar market for high-return opportunities.

Taken together, these factors are transforming private company stock into a mainstream asset class, with far-reaching implications for entrepreneurs and investors. "It is different than anything I've seen in my professional life," says Frank Hatheway, chief economist at Nasdaq. "This is a really interesting and exciting new part of the capital markets."

Finding ways to acquire a stake in unlisted companies is nothing new. Institutional investors gain exposure through private equity firms, and off-exchange trading can include shares in closely held companies. Such markets have matured in the past; Nasdaq, the US stock exchange where most technology companies trade, grew from an off-exchange system for securities transactions.

But there the shares were provided largely by the companies or their founders. Now, as employees and investors at well-known and profitable private companies sell their own shares directly to the highest bidder, a new twist to modern capital markets is emerging.

Case study: Millennium Technology Value Partners

[‘Facebook has had all the attention but we’ve done this in 40 companies’](#)

While it is [hot demand for shares of Facebook and other social media companies](#) that may soon go public – including LinkedIn, Twitter and Zynga – that has sparked interest in this market, it is not just Silicon Valley darlings whose stock is on the block. Shares in private companies across the US, in industries as diverse as energy, biotechnology and semiconductors, are being traded too.

Nor is the phenomenon confined to America. Interest is developing internationally, with Europeans acquiring stock in private US businesses, and shares in Israeli and Chinese tech companies being bought on the secondary market.

However, trading in private company stock remains largely unregulated and, Mr Hatheway warns, could spiral out of hand as investors chasing the next big thing are increasingly attracted to obscure unlisted businesses. “Once you get people interested in trying to make a quick buck, you get people not asking questions, and there can be more instances of fraud,” he says. This, he says, could attract the attention of regulators.

The rise of the private market is largely the result of weakness in its public equivalent. At the height of the dotcom boom in 1999, the average venture capital-backed company going public in the US was just under six years old, according to the National Venture Capital Association. That year, 271 such businesses went public, raising \$20.8bn. Last year, just 12 venture-backed businesses went public in the US, raising a total of \$1.6bn. Their average age was nearly 11.

Those that do want to offer shares face a more hostile environment on public markets. There are fewer analyst desks, making it harder for those with a small market capitalisation to gain exposure. The 2002 Sarbanes-Oxley Act, which set stricter accounting standards for public companies, has increased the costs of being public. Employees and early investors who find their exit paths blocked are therefore looking for new ways to turn their stakes into cash, and have turned to selling private stock.

Because private stock sales do not have to be reported, gauging the market size is difficult. Most estimates, however, put the total transaction volume well into the billions. Nypex, a New York-based advisory company specialising in secondary markets, estimates that \$2.4bn worth of such stock traded hands in the US last year. That figure could double this year, making this emerging secondary market stock one of today’s most dynamic new investment arenas.

Investment vehicles are being created to gain exposure to private companies, attracting capital from rich individuals and big-name institutional shareholders. “It’s a way to access the market a little bit more opportunistically,” says Marty Anderson, chief equities analyst at the state of Arizona’s retirement fund for public safety workers. The pension fund is among several that have become limited partners in the most recent fund raised by Millennium Technology Value Partners, a New York-based family of private equity funds that invests heavily in private stock.

Company-specific funds are also being created. Felix Investments, a New York-based investment manager for rich people, has set up single-purpose companies, each to invest specifically in [Facebook](#), Zynga and Twitter.

Traditional private equity firms are beginning to take secondary positions, too. [Elevation Partners](#), the private equity firm that counts U2 frontman Bono among its partners, has acquired as much as \$210m in Facebook shares this way.

Not everyone is convinced that the market is sustainable. “We see [Facebook] as more of an isolated case,” says Robert Campbell, managing director at B. Riley, an investment firm. “It’s not easy for smaller companies to get liquidity.”

For the market to mature, it may be necessary for private companies, which have minimal disclosure requirements, to share more information about themselves. “Getting these companies on board is essential to making these markets work from a legal standpoint,” says Darian Ibrahim, a professor at the University of Wisconsin Law School who has studied private stock sales.

Concerns exist that an information asymmetry between buyers and sellers could spark lawsuits, even regulatory action, in the event that some investors get burnt. “You’re dealing with billions of dollars of securities being bought and sold in a non-transparent situation,” says Mitchell Littman, a lawyer who advises private companies. “There’s no information out there about the issuers.”

Executives and shareholders close to the market dismiss these concerns. “People have realised that the fastest-growing, most interesting companies are the private ones,” says Barry Silbert, chief executive of SecondMarket, an online marketplace for assets not traded on public exchanges. “A broad group of investors is gaining access to these companies.”

SecondMarket, which says private stock is its most rapidly growing traded asset class, has completed more than \$250m in transactions in such shares this year, in almost 40 companies. While Facebook was the first to be sold on the exchange, lesser-known companies such as Acronis, a data storage business, and Bridgelux, a maker of light-emitting diodes, are among those most actively traded today.

When Startup:Education does sell its Facebook shares, the foundation may earn much more than \$100m. The social media group’s estimate of its own worth, which it used to value Mr Zuckerberg’s donation, trails what investors are willing to pay for a small slice, with trades on the secondary market [giving it an implied valuation as high as \\$33.7bn](#).

Such high prices can complicate life for private companies, which must take external trades of their shares into account when they appraise their own valuations. “Most companies would just as soon make this go away,” says Mr Campbell. “For the most part this creates nothing but problems for them.”

Active trading on the secondary market also increases the likelihood of exceeding 500 shareholders, at which point the US Securities and Exchange Commission requires the disclosure of significant financial information. Hitting this marker was one of the factors that caused Google to go public in 2004. Facebook says it remains below 500 shareholders.

Many are finding ways to exert control over trading of their shares. Instead of giving new employees stock options, larger private companies are giving out restricted stock units, which are redeemable only upon an exit and cannot be bought and sold on the secondary market.

[Facebook in April implemented an insider trading policy](#) that banned employees from selling on the secondary market outside specific trading windows. LinkedIn has asked SecondMarket not to sell shares to parties other than existing shareholders.

Almost all private companies also retain the right of first refusal to buy shares back, and many will assign this right to an existing shareholder who has an appetite for more exposure, thereby keeping down the overall number of investors. [Mail.ru](#), the Russian group formerly known as Digital Sky Technologies, which invested \$200m in Facebook last year, has used this strategy to accumulate nearly 10 per cent of the American social media group.

Zynga and Facebook have instituted steep fees for trades on the secondary market – partly to offset legal fees associated with handling the trades, partly to discourage the prospect of rampant flipping.

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Although trading on the secondary market can create challenges for companies, it can also be a powerful incentive for young employees who do not want to wait until they leave to realise some of the value they have created. “At a certain point, entrepreneurs get tired of sleeping on futons and eating Doritos,” says David Weild of Grant Thornton, the London-based advisory firm, who has followed the market for private stock.

Take Joshua Pritchard, who joined Facebook in 2006 and received three rounds of stock options. After leaving the company this year, he sold roughly half his equity through SecondMarket, netting several hundred thousand dollars. “It seemed sort of crazy to have 99 per cent of my net worth tied up in Facebook pre-initial public offering shares when the private market was providing an option for liquidity,” he says.

People familiar with private stock believe Mr Pritchard is at the vanguard of a phenomenon that is reshaping both how private companies operate and how investors allocate their capital. “We’re in the first inning of this ballgame,” says Laurence Allen, chief executive of Nypex. “There is huge pent-up supply and demand.”

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