

## Venture Capital's Pawnbroker

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Everyone, it seems, wants to be a venture capitalist these days.

It's not just Al Gore and Ashton Kutcher anymore. Larry Summers, Mary Meeker and Biz Stone all recently joined venture capital firms. Blogger Michael Arrington kicked off quite a kerfuffle when he announced he was starting his own venture fund.

Corporations are getting in on the action too: AOL is the lead investor in Arrington's CrunchFund, Nike recently set up its own startup incubator and Comcast just launched Comcast Ventures, a \$750 million fund. Even the NFL's drinking the Kool-Aid: The league is pooling owners' money into a VC fund to back sports-related technology startups.

It's far too early to say how these funds will fare. But the last time this many rookies piled into the venture capital business it did not end entirely well. Remember Enron and Worldcom? Both had venture funds. So did former San Francisco 49ers tackle Harris Barton and defensive back Ronnie Lott. The two cofounded HRJ Capital LLC in 1999 and showered capital from the likes of Peyton Manning and Barry Bonds on startups at bubble-era valuations—only to watch their fund implode ten years later.

Venture capital is now regaining some of its late 90s luster thanks to the successful IPOs of LinkedIn, Pandora, Groupon and Facebook's much anticipated public offering in 2012. But an inconvenient truth remains: Casinos always win and suckers inevitably lose their shirts.

At the NASDAQ's peak in 2000, there were 1,022 venture capital firms. Less than half are alive and kicking today. For the past ten years, VC firms returned—on average—an abysmal negative 4.6% to their investors. They would have been better off blindly throwing that money at the Dow Jones Industrial Average (2.5%) over that same period, according to Cambridge Associates.

If history is any guide, the more dumb money that chases startups at sky-high valuations today, the more distressed sellers there will be trying to unload their shares down the road.

That should ultimately bode well for seasoned secondary investors like Hans Swildens.



*Industry Ventures' Hans Swildens*

In venture capital circles, Swildens is known as something of a pawnbroker. His secondary fund, Industry Ventures, has a knack for buying startup scraps on the cheap and turning them around for a tidy profit. The firm is still picking over the remains of firms that raised large funds at the bubble's peak in 2000 and are now well past their ten-year time limits with limited partners anxious to cash out. Swildens estimates over 900 firms fall into this category.

Swildens first set about acquiring secondary stakes in companies in the wake of the dotcom crash in 2002. Back then he was buying stakes from distressed corporations looking to quickly unload their venture portfolios and nervous limited partners and founders looking to free up illiquid assets. He acquired Enron's venture portfolio in a bankruptcy proceeding in 2002. In 2003, he acquired Bowman Capital's venture portfolio at a steep discount. Bowman had formed a \$500 million fund at the top of the bubble. Less than four years later, it was forced to liquidate its holdings to Industry.

"The valuations paid in 1999 and 2000 were fake," says Swildens. "By 2002, everything sold at a loss. Most things we purchased were between 70 and 90 percent off their original invested capital."

In 2006, Industry Ventures acquired a one percent stake in Ancestry.com from Hollinger Capital, the venture arm of Conrad Black's now defunct newspaper holding company. Through its stake, Industry Ventures could see that the young startup had long-term growth prospects. So it set to work acquiring more shares from over a dozen stakeholders including corporations, old executives and founders in need of liquidity.

By the time Ancestry.com went public in 2009, Industry owned five percent of the company and had more than quadrupled its investors' money.

Industry has replicated that investment model over a hundred times. It acquires equity in startups—often on the cheap— via a hodgepodge of sources: venture funds in wind down mode, pension funds and endowments looking to purge long-term illiquid assets from their portfolios, or just founders, VCs and angels starved for a little liquidity.

In the process, the firm has built up an intricate information network. Through its investments in VC funds, the firm can see which startups are outperforming and which are rotting in portfolios. Given the opportunity to scoop up more shares in a company from another source, it knows when to pounce and when to pass. Likewise, Industry also has a unique vantage point from which to evaluate venture capitalists themselves. The firm is considering patenting its "GP ScoreCard"—a ranking of venture capitalists based on the quality of their investments (much like our own Midas List.)

"They're diggers," says Larry Marcus, an early stage VC who invested in Industry's last three funds and simultaneously counts the firm as an investor in his own fund, Walden Capital. "They know what's going on in the different portfolios. They have their ears to the ground. They know what's working and what's moving. That intelligence is a huge competitive advantage for them."

Industry's network has helped the firm score coveted, early stakes in much hyped companies like Facebook, Twitter and Zynga, long before these companies traded on SecondMarket or SharesPost.

Industry acquired its Facebook shares from early employees prior to 2009, when the social network's valuation had not yet hit \$10 billion. (Today, secondary shares of Facebook trade above \$80 billion). It acquired a sizeable stake in Twitter through Lowercase Capital, the seed stage venture fund that was one of Twitter's earliest investors. Industry was the first institutional investor in Lowercase and helped its founder, Chris Sacca, create his first fund (Industry's back office still does the accounting on it). The two co-invested in a second fund, Lowercase Industry LP, that Sacca used to initially acquire Twitter shares. And in the case of Zynga, Swildens' firm is a limited partner in Foundry Group, the firm that invested in Zynga's Series A (or first round).

Swildens says those companies have helped legitimize the role of the secondary market into “One that is helpful to the ecosystem,” says Swildens. “A lot of the sellers we buy from today are taking profits. Ten years ago they were taking losses.”

When Swildens first started investing in 2002, most secondary deals were done in the Silicon Valley equivalent of dark alleys. “There was a stigma,” says Swildens. If you sold shares in a company before its IPO or acquisition it was seen as a sign of duress. Either the company was in trouble, or you were. When Swildens first started cold-calling venture capitalists and founders to discuss possible share transfers in 2002, he says the typical response was: “How did you get this number?” Or, “How quickly can you sign a non-disclosure agreement?”

Today, the secondary market is a thriving part of the venture ecosystem. Nypdex, a firm that tracks secondary sales, estimates that some \$22 billion worth of private company and private fund shares changed hands last year, up from virtually nothing in 2000.

Even brand name VCs—once loath to the idea of selling shares to a third party—made several secondary trades recently. Accel was able to repay the entire capital base of one fund just by selling a sliver of its Facebook stake to Andreessen Horowitz and others last year. And Kleiner Perkins scooped up secondary shares of Facebook last February. In both cases, those shares sold for a significant profit.

Industry Ventures’ fund sizes reflect the growing market for secondary deals. The firm just closed its largest fund to date— a \$400 million fund and a \$155 million “Special Opportunities Fund,” bringing total capital under management to over \$1 billion. (The firm closed a \$105 million fund in 2005 and a \$265 million fund in 2008.)

Swildens says 85 percent of the firm’s exits come from IPOs and M&As. But the remaining 15 percent of Industry’s liquidity events are now secondary sales.

“We’ve started selling secondaries ourselves,” says Swildens. “Which tells you how big the market is now. When secondary funds are starting to sell secondaries.”