The New Financial Matchmakers

The rise of private market networks is changing the capital markets and opening up new opportunities for business leaders and innovators.

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In that ancient, un-networked world where public stock markets evolved, those markets were the only way that nascent companies could reach huge numbers of potential investors and that investors could trade with one another. Investment bankers and their well-established interrelationships provided the only practical path for finding merger or buyout candidates. And the key technologies for marketing your new hedge fund or selling your limited partnership interests were the (landline) telephone and your broker’s Rolodex.

Surprisingly, perhaps, that world has survived largely intact to this very day, but it’s all about to change. Now, private market networks (PMNs), such as SecondMarket, AxialMarket, and Angelsoft, are starting to do for the capital markets what eHarmony did for dating.

The idea of using the Internet to match buyers and sellers of financial products is not new, of course; it’s been talked about since eBay got started in the mid-1990s by creating a liquid market for broken laser pointers and Pez candy dispensers. Innumerable online bulletin board services for investors have been launched, with limited success. But a new generation of private securities platforms that have begun to emerge over the past few years provides much more: opportunity discovery and recommendation engines; analytics and evaluation tools; secure virtual diligence rooms with tiered access rights; industry benchmarks and comparables; standardized documentation and fee terms; deal, and deal flow, management systems for both the buy and sell sides; and lists of experienced service providers to consummate transactions. These platforms also offer a reach equal to that of the Internet itself, something not even public exchanges can offer.

One might think these developments are simply a natural consequence of the adaptation of the investment world to a networked, online environment. But that would understate both the reality and the ramifications of PMNs. The fact is that these new networks are enabling, and are enabled by, some fundamental changes in the life cycles of businesses and investments.

Let’s look at early-stage venture capital as one example. In our time of hyper-rapid change, corporate organisms are becoming more like fruit flies than elephants: Intense evolutionary pressures favor more, shorter generations of faster, lighter companies. Indeed, as David S. Rose, the founder of Angelsoft, points out, the capital necessary to launch new companies is falling by more than an order of magnitude per decade; at the same time, accelerating societal and technological changes limit the expected lifespan of new companies. That means many startups are too small to interest most venture capital firms, and at their zenith they may still be subscale for either an initial public offering or a traditional investment bank M&A process. The few startups that reach truly large scale often neither require the massive capital that IPOs offer nor wish to forsake the luxury of private life for the glare of the public company spotlight. As a result, even the most successful new companies frequently seek...
to satisfy their (relatively modest) liquidity requirements through private transactions.

Enter PMNs. Against this backdrop, they help entrepreneurs and angel investors find one another without the intervention of venture capital firms; provide liquidity for employees and early investors in pre-public companies (such as Facebook, Twitter, and Zynga, to name just a few); and allow business owners to find growth capital, strategic buyers, and merger partners.

The impact of PMNs outside the world of operating businesses is no less dramatic: They help match investors with hedge funds and private equity funds, and create secondary markets for both; offer liquidity for out-of-favor financial instruments such as failed auction rate securities and collateralized mortgage obligations; and even raise the prospect of active markets in traditionally illiquid assets such as art and wine.

Some leading PMNs include Angelsoft, IndieGoGo, and Kickstarter (early-stage funding); SecondMarket (the largest PMN, operating in several asset classes); SharesPost (later-stage pre-public stock); AxialMarket (lower mid-market M&A); Xpert Financial (growth capital); EquityNet (multi-stage equity); the New York Private Equity Network (private equity partnership interests); and Hedgebay and Lincoln Square Advisors (hedge fund investments).

Although still small by Wall Street standards, PMNs are growing quickly. For example, SecondMarket closed some US$10 billion in illiquid securities transactions in 2010, a fourfold increase from the prior year, including some $400 million in pre-public equities. At the same time, the number of ventures applying for funding through Angelsoft now exceeds 4,000 globally every month; companies listed for sale via AxialMarket have combined revenues approaching $50 billion; and the bid and ask listings on SharesPost already exceed $1 billion.

AxialMarket provides a good example of the genre. This network allows business owners and their representatives to offer their companies for sale to hundreds of institutional buyers, including public corporations looking for new technologies or products, and private equity firms with cash and management teams. When a company joins the network and provides its basic information, the system automatically generates a traditional “teaser” (a one- or two-page brief that outlines an investment opportunity without identifying the company) and then suggests particular acquirers based on the potential buyers’ previously registered preferences. The listing company can choose which of these should get the teaser, and the recipients that are interested in the opportunity can then execute online nondisclosure agreements to gain access to company management and virtual diligence rooms. Both sides can manage and monitor the progress of the deal through the platform. Of course, eventually, humans do meet to negotiate and document the transaction; but the online discovery and initial evaluation processes are huge improvements over conventional practice in the mainstream capital markets.

Business leaders should welcome these developments. Aside from online brokerage accounts, the vast majority of “innovations” in the capital markets world during the past 30 years have centered on creating and packaging securities that distribute risk in narrow asset classes, such as home loans. Although these innovations have contributed mightily to Wall Street profits, they have done very little for new business formation, and have in fact done much harm. These days, the overall economy is awash in liquidity (bank reserves exceed $1 trillion, up from about $50 billion in mid-2008), but these dollars currently appear dedicated to purchasing and selling zero-risk Treasury assets, financing investments in higher-yielding foreign investments, and chasing...
hot commodities. Meanwhile, the Street’s creative energy has turned to computer systems that trade massive quantities of shares thousands of times per second to exploit microscopic arbitrages. New alternatives are needed, not just for the sake of the entrepreneurial economy, but for investors: Cash-generating businesses are, after all, more reliable inflation hedges than talismanic metals.

Some reasons that PMNs should prove very successful are obvious: Just as eHarmony allows would-be mates to find each other, perform a little due diligence, and establish an initial relationship, so too do PMNs allow companies and investors to locate each other and then efficiently narrow down the field of potential business partners. Today, 20 percent of all romantic relationships in the U.S. begin online, and there is little reason to suspect the corporate analogs will be less successful. And, of course, not only do private market networks perform introductions better than traditional intermediaries (because of their reach and speed), but they are also inherently less expensive, replacing humans and office space with nearly free network connections and servers.

More subtly, PMNs also perform the important function of disambiguating which fees are paid for what. For example, company owners normally pay big investment banking fees for basic knowledge of how the sales and money-raising processes work, access to the relevant institution’s relationship network, and the banker’s skill in structuring and negotiating the best possible deal. In a robust PMN, the first two elements are eliminated from the equation. As PMNs proliferate, investment bankers will be competing for fees based on more fundamentally valuable skills — those relating to creating the best possible deal structures and terms for their clients.

The regulatory situation concerning private market networks appears relatively clear. Generally, the resulting transactions must qualify as “private placements” (so that purchasers are limited to institutions and affluent individuals) and must be conducted through registered broker-dealers. But because PMNs generally do not provide execution capabilities, they should escape regulation as “exchanges.” (That said, one recent development does show how the line between the public information available to secondary buyers when the company is not itself involved in the transaction.

Private market networks offer a powerful vision for a more effective, efficient global capital allocation system. The history of the Internet tells us that if they are left to develop on their own, PMNs will proliferate and help accomplish the transition from an industrial economy to an information economy. Perhaps the biggest risk to this optimistic scenario is that legislators and regulators will intervene and overreach in the name of “protecting” high-net-worth investors (as the original Dodd–Frank bill would have done in the U.S.) and “strengthening” existing institutions and processes by effectively limiting competition (as the final bill did). If government officials around the world allow this new global network to multiply the natural power of capitalism, if the requisite levels of transparency and trustworthiness are fostered in the design of these systems, and if business leaders and investors recognize the value of more direct interaction, then the new networks for allocating capital will rapidly take their place alongside more established exchanges — and could even begin to displace them.

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