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One Start-Up's Plan To Fix IPO Market

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With the IPO market frozen solid, venture investors continue to struggle with liquidity problems. Ironically, some are pinning their hopes for a fix on a start-up.

InsideVenture Inc., backed by half a dozen venture firms including New Enterprise Associates and Venrock, looks to build a private market where large institutional investors could vet later-stage venture-backed companies and perhaps invest in them before a public offering.

That would help companies by improving access to pre-IPO financing and giving them a stable base of long-term investors. Institutional investors such as mutual funds would benefit by getting a better shot at the kinds of companies whose IPOs in recent years have been steered to short-term traders by investment banks. And, venture firms hope, it could also provide early investors and entrepreneurs with a venue to sell some or all of their stock.

InsideVenture launched last year and is preparing for its debut investors' conference in March. Mona DeFrawi, the company's chief executive, spoke to us about the state of the IPO market, the goals of InsideVenture and some of the obstacles it faces. Here is an edited excerpt from the recent Q&A session:



What are the obstacles to IPOs by venture-backed companies?

Ms. DeFrawi: I think the obstacles actually have been forming over the last seven years, almost like a perfect storm that has come to a culmination in 2008. Some of the factors that have been key in this are the Internet bubble burst that freaked a lot of people and increased the profile of risk in investors' minds. At the same time that was happening, those [investment] firms that actually did a lot of the tech IPOs in the '90s very successfully disappeared and were consolidated into the larger firms who had a different cost structure, which helped them define the market with bigger IPOs. You also had Eliot Spitzer's work (separating analysts from investment bankers). The investors had less research, less information to base their decisions on.

And at the same time, more and more of the IPO buyers coming in were hedge funds and short-term focused investors. If you look historically at IPOs over the last seven years, many of them have traded down. Sometimes the share price is more a function of the trading logistics of a stock and has less to do with the actual value that the company is creating,

How does InsideVenture look to help resolve these problems?

Ms. DeFrawi: The first thing that we can do is get a nice, healthy shareholder (base) for companies as they move toward IPO. In the last seven years, more IPO allocations were primarily going to a (short-term) audience. We work with investors who have a long-term focus, so they're looking to create value by building companies that create real products and real profits and not just looking to make a quick dollar off of a trade.

Will this primarily be a way for companies to bring in additional investors or will it be a way for prior investors, management and founders to sell shares?

Ms. DeFrawi: I think this is primarily a way for the buy-side [investors] to get to see the very best companies. Part of the reason we were created is that buy-side firms that have been involved with us from the inception said they weren't even getting allocations over the last seven or eight years because these allocations were going to other, shorter-term focused clients who were generating more deal flow. The long-term investors will hold the stock for five to six years on average so they're not generating as much activity. That's why a lot of public buyers are doing late-stage investing, because they get in at an earlier stage.

When do you think the IPO market will be more receptive to companies that have gone this route?

Ms. DeFrawi: There are very, very profitable companies that don't need to do any financings, so they don't have to do an IPO right now. But eventually it's really important for companies to have [IPOs] as an avenue if we're going to continue to expand economic growth in this country. So I do believe it is inevitable that the IPO market will come back, even if we grow a really healthy, robust private financing model. I think it's going to come back a lot sooner than people think it will. I think attitudes do not reflect the actual real value and real economics of what

exists today.

What are the biggest obstacles to your operation?

Ms. Defrawi: I think probably the biggest obstacle is that we're so new, this has never quite been done before, coupled with the very difficult economic time, it's created skepticism. But when you look at the people who've put this together and how long they've been involved, this isn't coming up out of the blue. This was designed and it was envisioned from years ago. The trends were seen, so this is part of a flow of natural trends, of natural evolutions in the capital markets.

So the bottom line is, you think you can function with the existing rules?

Ms. Defrawi: No, I think some of the rules need be reformed. For example, the point at which a company would go public in the 1990s is no longer available to companies now. Companies must be at a much larger market cap, many more years in development, many more tens or even hundreds of millions of dollars invested prior to being able to go public. That's a huge hurdle to be surmounted. In the process, what we've done is added regulation, added Sarbanes-Oxley, which is there to protect shareholders. However, there are many in the industry who believe that we've over-regulated at that point and raised the cost for companies at such a high level that we're making it difficult for American companies to compete.

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