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Road to IPO Slows, Creating Retail On-Ramps

By Peter Ortiz

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Retail investors often lose out to institutional or qualified investors who lock in on an attractive share price before a private company goes public, but that may be changing.

In part, that’s because private companies are staying that way longer, creating a greater lead time for managers of retail-investor-focused funds to get in the door, analysts and sponsors say.

The ’40 Act imposes limitations on how much mutual funds can invest in illiquid securities, but managers at companies like Fidelity, T. Rowe Price and **SharesPost Investment Management** say exposure to not-yet-public companies can give retail investors in growth-oriented portfolios a meaningful boost.

Longer lead times also have coincided with higher valuations for big companies that do IPOs, says Andrew Boyd, head of global equity capital markets at Fidelity. Without access, the retail public is missing out on a “big piece of wealth creation,” he says.

Fidelity sprinkles pre-IPO exposure from different industries across several funds and typically looks at companies that are between four and 15 years old, he says.

Two or three decades back, venture capital–backed companies typically went public after six or eight years, making it challenging for ’40 Act funds to acquire meaningful stakes during crucial growth phases, says Sven Weber, president of SharesPost Investment Management.

“Today it takes 10 to 12 years for venture capital companies to get acquired,” Weber says. That allows more time to maximize shareholder return, he says. ”So we are looking at companies that are typically seven to nine years old, have $50 million to $100 million minimum revenue and that grow 30% a year in revenue.”

Earlier this year, the San Francisco–based firm launched a closed-end fund that touts early access to a pipeline of pre-IPO firms.

“It is a very inefficient market, but that is what makes it so attractive,” Weber says.

The SharesPost 100 Fund invests in equity securities of private, mostly technology, firms in the late stages of growth, according to the fund’s prospectus. Companies on the SharesPost 100 List include well-known brands such as BuzzFeed, DropBox, LegalZoom, Spotify, Uber and ZocDoc.

That list is adjusted quarterly and will be 80% invested in these firms. Currently, the portfolio invests in 17 of them, but is expected to grow to between 50 and 70 companies as the fund gains traction with investors, says Weber, who is also the fund’s manager.

The fund represents about $17 million in assets. The fund traded at its net asset value of $24.24 as of Monday, and is still in the process of raising assets.

The SharesPost 100 does not aim to be invested in firms when they become public. If the company goes public, the fund has to hold it for at least 180 days before it can sell it, according to the prospectus. Prior to launching the fund, Weber served as president of Silicon Valley Bank Capital and managed that firm’s venture capital investing business.

Fidelity uses small amounts of pre-IPO exposure in dozens of open-end growth funds, including the $8.4 billion Fidelity Select Health Care Fund. But such holdings generally make up only 1% to 2% of the investments in the respective funds, he says. And, unlike SharesPost, Fidelity sticks with companies after they go public.

Indeed, opportunities are growing, with Boyd's group reviewing 150 private companies this year compared to 100 last year. Fidelity chooses only those firms focused on at some point going public.

"We're not chasing two guys with an idea in a garage in Silicon Valley," Boyd says. "We are looking for real companies beyond the venture stage." Fidelity's size means that the firm can offer access to capital that companies may no longer be able to get from venture capitalists, he says.

Like Fidelity, T. Rowe Price uses pre-IPO exposure in several funds, including its $15.3 billion New Horizons Fund. That product, which closed to new retail investors Dec. 31 last year, invests in a "diversified group of small, emerging growth companies, preferably early in the corporate life cycle before a company becomes widely recognized by the investment community," a firm spokesman writes in an e-mail response to questions.

The Fidelity Select Health Care Portfolio has outperformed its Morningstar category year-to-date, returning 32.4% versus 26.6%, and has outperformed its category for the one-, three-, five- and 10-year periods. T. Rowe's New Horizon's Fund also outperformed its Morningstar category year-to-date, 4.8% versus .43%, and outperformed its category for the one-, three-, five- and 10-year period.

But holdings of such companies "tend to represent a fraction of a fund's total net assets," the T. Rowe spokesman adds.

Morningstar senior analyst Katie Reichart notes that while the New Horizons Fund is a small growth fund that invests mostly in public companies, its manager, Henry Ellenbogen, spends significant time looking at private companies. One example of such a company was Twitter.

"If you are an early investor it gives you a runway for longer return/growth," Reichart says.

In addition to helping managers understand emerging technologies, being invested in a private company also may have more wide-reaching benefits, she says.

"From a research perspective, it can help him more broadly across the portfolio," Reichart says.

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