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Busting the Myth That There's Little Data on Private Companies

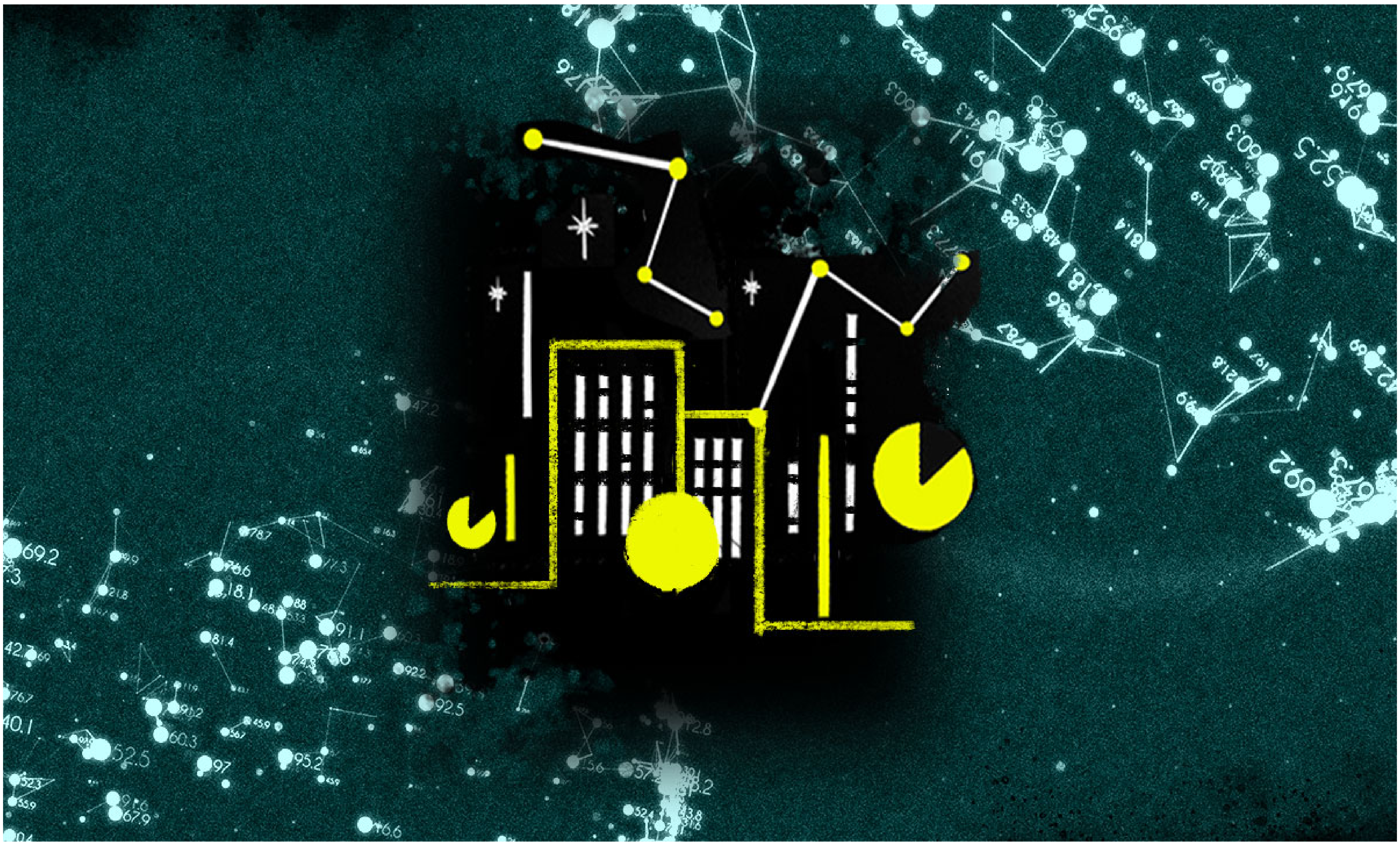

Illustration by II

The SEC says there's "absolutely no visibility" for investors when it comes to unicorns, but there is a vibrant and growing market for data and information — at least for some.

By Julie Segal   January 20, 2022

The Securities and Exchange Commission, Wall Street's most important regulator, says there's a huge risk in allowing big private companies to live in an information black box, and it is working to rectify that with new disclosure rules. But while the hidden risks the SEC wants to address are real, it's a myth that there's a dearth of data available on companies that live in the private markets, particularly later-stage startups and unicorns valued at more than $1 billion.

Private businesses aren't subject to the same disclosure rules that squeeze a constant flow of information from publicly listed companies, but a competitive and robust market for data on private companies has developed nonetheless. That's because there's money to be made on all sides of the information scarcity, and Wall Street always finds a way to fill a vacuum.

“People [automatically] say there is no data, or the quality [isn’t good], but if you look closer, you can find the data and enough of it,” says Ziad Makkawi, founder and CEO of EQUIAM, who started his career in 1986 as a currency and derivatives trader at J.P. Morgan.
In fact, Makkawi started EQUIAM on the premise that there’s plenty of available data that can be used to identify good investments using algorithms, a development that would allow the company to compete with traditional venture-capital firms.

He thinks of EQUIAM as one of the first VC quants — in other words, a firm that allows smaller institutions and more mainstream investors to get a shot at the clubby world of Silicon Valley-funded companies, especially those in the later stages. (Tribe Capital, the VC firm started by the former partners of Chamath Palihapitiya’s Social Capital, also uses a quant approach to venture investing.)

EQUIAM is leveraging the odd fact that Silicon Valley may have underwritten technology behemoths like Alphabet, Facebook, and Amazon, but its investing process generally doesn’t involve using data to pick investments.

“The way people invest in venture capital hasn’t changed in 70 years,” Makkawi tells *Institutional Investor*. But the sheer size and growth of a secondary market for both investors’ stakes in funds and shares of individual companies has essentially scattered data about private companies around the industry. Last year, venture capital raised a record amount of money and the secondary market reached a high of well over $100 billion. With companies staying private longer, they have to do multiple rounds of fundraising, and each time they release financial information to a long list of potential investors, auditors, and technology providers.

“With the growth in primary and secondary markets for private companies, both in size and transaction volume, there is enough data being produced that I can approach this market with a systematic investment strategy,” says Makkawi. EQUIAM analyzes 120,000 companies and 10 million data points to find the companies in which it will invest.

Phil Haslett, founder and chief revenue officer of EquityZen, a platform designed to buy and sell pre-IPO companies, agrees that there is plenty of information floating around, but he questions how accurate it is. Although EquityZen would benefit if the SEC required private companies to disclose more information, Haslett points out that regulations are needed to level the playing field.

“My general thesis is that if you’re a company that has raised a couple of hundred million in VC or growth equity money, no one really wrote you [that] check without going through your financial information and going through a data room and conducting their own due diligence — and in all likelihood you probably had audited financials too,” Haslett says. “I reject the premise in which companies, their law firms, or the NVCA [National Venture Capital Association] say, ‘With all this extra burden, what’s the point of these companies staying private if they have to do this?'”

He doesn’t expect the SEC to require private companies to file anything like 350-page, pre-IPO S-1s. “I think there will be a lighter version,” he says. “More transparency is important. Otherwise you have information asymmetry that is really beneficial to people who can afford it: hedge funds and institutions.”

institutions.

Data on private companies includes paid sources such as PitchBook and Preqin, as well as other alternative data providers that collect niche but often insightful information, such as how many times a CEO takes private aircraft or how the social media sentiment about a company is trending. Publicly available information can also be gleaned from S-1 filings; the prospectuses of special-purpose acquisition companies (SPACs), which invest in private companies; and the legal documents involved in de-SPACing. Companies are in the same boat as individuals, who can't always control their once-private information.

But it's not only the availability of raw information that has made private markets less of a black box. Artificial intelligence and data science techniques have allowed investors and other startups to gain sophisticated clues from patchy data and to better judge the quality of the information they've collected.

EQUIAM, for instance, uses AI and data science to scrape and analyze information, including, among many other things, capital raised, metrics such as momentum and value, revenues, and the growth of revenue per employee. It can gauge how well startups have used the capital raised between rounds and how likely it is that later-stage companies will converge with their public-company peers once they IPO.

Data has also bubbled up about unlisted companies, because a crop of new investors — including mutual funds, hedge funds, private-equity firms, and sovereign-wealth funds — are active in growing private markets. All the activity has allowed data points to dribble out along the way. At the same time, the industry is eager to offer private equity and venture capital to mainstream investors through advisers and 401(k) plans, which will turn on a spigot for information about these funds and companies. With the number of public companies shrinking as founders look to escape regulations, as well as the easy access to a growing pool of capital, people argue that individuals need a way to access these markets.

Hedge funds, for example, add a new data trail every time they conduct a secondary transaction, participate in a new round of fundraising for a startup, or buy a stake from an investor who wants to cash out before a private-equity fund's life is up. Hedge funds Tiger Global Management and Coatue Management are now some of the biggest dealmakers in the private markets. Mutual funds that buy stakes in private companies are required to share far more information with shareholders than traditional VC firms ever did.

Then there are platforms like Forge Global, Carta, and Nasdaq Private Market, which have sprung up to provide early-stage investors and employees with the ability to buy and sell shares of private companies. To do that, participating companies have to share more information with the platforms, which has allowed the platforms to grow into valuable data warehouses.

Eight-year-old Forge is even planning to go public. In September, the firm created Forge Intelligence, a separate data arm. Forge has about 400,000 accredited investors on the platform, along with 700 financial institutions, including hedge funds, VC firms, family offices, and private capital market desks.

Kelly Rodriques, CEO of Forge for the last four years, says one of the problems his company wants to solve is information and pricing transparency. “In 2019, when Peloton went public, a late-stage VC sold a $75 million pre-IPO position that it had held for years on Forge to a hedge fund. That allowed the VC to sell a portion of the holding before the IPO, because they discovered market-based pricing on Forge,” Rodriques says. He adds that there are more than $10 billion of what are called indications of interest, or IOIs, sitting on Forge at any given time. “You can find out the very last trade in Airbnb before it went public,” he says.

These platforms have created extraordinary transparency. “Before Coinbase went public, we knew what it was trading at in the secondary market,” says EQUIAM’s Makkawi. “In the old days, it was like the dark side of the moon — from one funding round to another, you had to wait.”

That’s helping portfolio valuation, which has long been a concern for investors and regulators, who worry about the subjectivity involved in pricing portfolio companies.

Vidya Eashwer, who joined Forge from Intercontinental Exchange to run the data business, says, “Before, valuation was based on funding, but that can happen every three years. It is stale. What we’re seeing is that it is moving more real time and to more current pricing. Price and valuation is more reflective of what market participants think the value is today versus three years ago.”

Data has always been valuable in the financial industry. In fact, the story of finance over the last 40 years has been about who has data. The less data there is about an asset class, the more rewards people with the appropriate knowledge can milk from the investments.

VC is no different. “Look at traditional VC — the reality is that they have been building competitive moats by hoarding data,” Makkawi says. “Their ability to access this data gives them their superpower in growth and late stage.”

But as data becomes more available and the sector more crowded, investors who want to be in more undiscovered areas of the market will move on. At the same time, mainstream investors can benefit. EQUIAM’s vision is to be a venture version of the stock index fund, which was also only viable once data on stocks was widely available.

“If you look back ten years from now, this will be a pivotal point, where you have traditional long-only managers disrupted by ETFs on one end, and at the other end you have private equity, VC, institutions, hedge funds, and high net worth,” says Vijay Advani, executive chairman of Nuveen and adviser to EQUIAM. “This is square in the middle. This is trying to bridge the gap and provide what was historically only accessible to the largest institutions [to] the mainstream.”

Both Makkawi and Rodriques believe the increased availability of data will ultimately push VCs back into earlier-stage and seed-stage companies, just as active managers moved to less efficient parts of the market once index funds provided cheap and effective exposure to segments such as large-cap stocks.

While the SEC may be wrong in saying there’s no transparency when it comes to private companies, there's still value in having private companies disclose more details about their underlying businesses. These companies, after all, may ultimately dwarf the number of listed stocks releasing arcane details in real time.

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