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INDUSTRY NEWS

Exits Are Few These Days. So One Fledgling VC Firm Created Its Own

Instead of waiting for IPOs to revive or acquisitions to pick up, Santa Barbara Venture Partners has been selling shares of its portfolio companies. The sales might also help the young firm draw investors to its second fund.

By Marc Vartabedian

April 8, 2024 6:00 am ET | WSJ PRO

Headquarters of Santa Barbara Venture Partners. PHOTO: RADIUS COMMERCIAL REAL ESTATE

These are tough times for young venture-capital firms. Fielding a second fund can be a tough sell for a firm with few, or no, exits under its belt. And exits have been scant lately.

One firm, however, says it's found a way to beat the "sophomore slump": secondary sales.

Last month, Santa Barbara Venture Partners took the unusual step of selling shares of its portfolio companies to generate capital to return to its limited partners. Sales are by no means traditional exits—investors generally expec cash-outs like initial public offerings or acquisitions. But the secondary transactions have shown that SBVP can make money for its investors, said Dan Engel, its founder and managing partner.

The early-stage firm is raising its second fund and the returns it has made on its recent secondary sales have caught investor attention, he says.

Dan Engel, founder and managing partner of Santa Barbara Venture Partners. PHOTO: KELSEY WITT

"It has changed everything and we're absolutely standing out," Engel said. "I wonder why more firms aren't doing this."

The strategy isn't common, says Kyle Stanford, the lead U.S. venture capital research analyst at PitchBook Data. The secondary market can be treacherous: Trades can be complicated to line up, or might come at steep discounts, he said. In addition, investors selling shares of a portfolio company could look like they're losing confidence in it, while at the same time wondering if they're missing out on its future returns.

Still, for a young firm eager to cobble together an earnings record, secondary sales could make sense, Stanford said.

Young venture firms have always faced a dilemma as to when they should raise a second fund, and recently it's been harder to pull off. Historically, about 63% of first-time managers are able to raise a second fund, according to PitchBook. For the cohorts that raised their first fund in 2019 and 2020, however, that figure has gone down, to 53% and 43%, respectively, the PitchBook data show.

Before jumping into a second fund, limited partners—the investors in funds—want to see proof a firm can make them money, and that's hard for new firms:

Exits might not occur for as many as seven years.

"If you want to raise another fund and you haven't returned capital and you don't really have a track record, how do you do that?" said Jeffrey Grabow, U.S. venture-capital leader at Ernst & Young.

As well, successful exits are infrequent these days. According to PitchBook, the number of U.S. startup exits in the first quarter fell 29% to 223 compared with the same period of last year, and were off 48% from the first quarter of 2022.

For SBVP, secondary sales have been a game changer, said Engel.

Santa Barbara Venture Partners launched in 2020, tapping small family offices and high-net-worth individuals, most of them local to the affluent coastal California city known more for surfing than startups. The firm targets startups that have established a market for which to sell their product or services. Engel said his track record as an entrepreneur and angel investor allowed him to put together the first fund, a roughly $11 million vehicle raised in 2020.

After targeting artificial intelligence, among other sectors, with the first fund, SBVP began raising its second in 2022. (Engel is prohibited by securities regulations from giving specifics on the fund.) But as the fundraising market began to sour, LPs demanded more proof of traction, Engel said.

SBVP had little to show. The firm had its first exit in early 2022 when crowdfunding platform GoFundMe bought Classy, one of its portfolio companies. But it was a stock transaction, so SBVP hadn't yet been able to sell the stock to distribute cash back to its investors.

"Fund 1 hadn't baked long enough," Engel said. "So you're out there saying, 'Give me money again,' and I totally haven't proven myself."

Some of SBVP's existing LPs said they wanted to invest, but had suffered recent losses and were short on liquidity, Engel said. If SBVP could return profits, they could contribute to the second fund, he said.

SBVP notched an exit in February when sports-betting company DraftKings agreed to acquire digital lottery app Jackpocket for roughly $750 million. SBVP's stake in Jackpocket amounted to roughly 6% of the firm's first fund, Engel said.

The firm wanted to build on that momentum. On March 6, it sold a quarter of its stake in portfolio company Bark Technologies, an AI software startup that helps parents monitor and control their children's online use, to an LP of a firm that had also invested in Bark.

Two days later, SBVP sold 10% of its stake in portfolio company Rad AI, which uses generative AI in the radiology field, to another venture firm.

The firm said it netted a 109% return on the Bark deal and 142% on Rad AI, and is in the process of distributing those profits to its LPs. SBVP still holds the majority of its positions in Bark and Rad AI, which are among the firm's best performers, Engel said.

Before those deals, meetings with prospective investors resulted in them joining the second fund about 30% of the time, Engel said. Now it's 80% to 90%, he said.

SBVP is working on another secondary transaction and Engel says the firm isn't deterred by the drawbacks or stigma of cashing out shares early.

"The thing that's most important is sending money back to your investors at a profitable return," Engel said. "If there are opportunities to do that where the return is in line with what you promised, that's what you should be looking to do."

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