Venture's liquidity release valve

Analysis of direct secondary markets for venture capital

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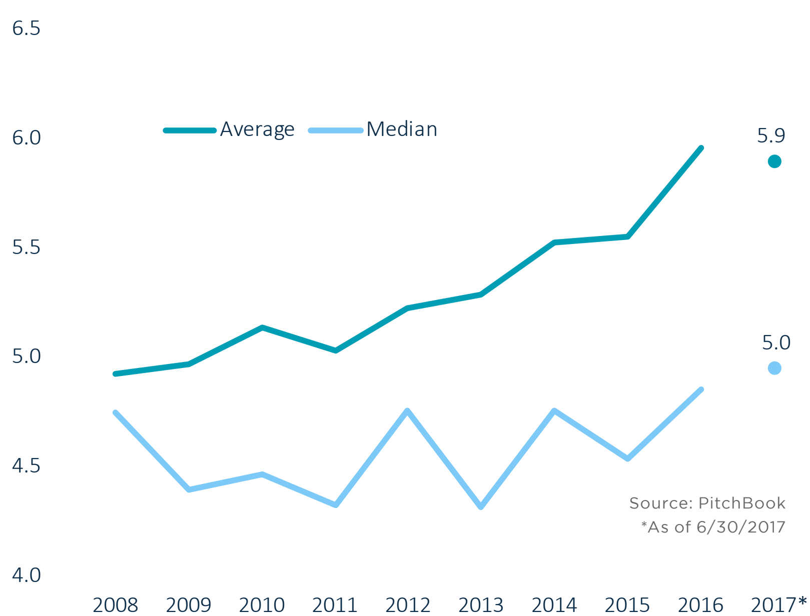
Introduction

Much of our previous coverage has acknowledged the ongoing and ubiquitous theme of VC-backed companies delaying exits and/or remaining private for longer. And while we have seen how that trend has suppressed exit volume and increased the average time to exit by 20% since 2008, this development has much farther-reaching implications. One example is the venture direct secondary market, where general partners or employees sell their shares of venture-backed companies, as opposed to the shares being sold directly by the company itself. Because of its station relative to the broader VC market and the liquidity options it provides, the secondary market is positioned to see increased participation when the exit environment is tepid. Although it is difficult to find data on the size of the direct secondary market, we have seen rapid growth across private secondary markets, while direct secondaries have become better understood since 2010 as shares of prominent private companies have become available. Yet, considering the size and growth of the overall venture market, we believe there is still a large runway for expansion.

Pathways to exit have steadily elongated
Time to exit (years) by venture-backed companies



Characteristics

Due to the illiquid nature of private company shares, the direct secondary market serves as a mechanism to provide liquidity for those who own individual private company shares. One of the main populations to utilize the direct secondary market are the employees of privately held companies. Many startups rely on equity compensation to pay employees to help mitigate their cash burn rate. While this can be efficient for the company, it can take years for employees to be remunerated. This issue has only intensified recently as VC-backed companies have been increasingly willing to push out the exit process. The direct secondary market provides a solution, allowing employees and insiders to realize value from their shares. As this market becomes more developed, it may alleviate some of the pressure for VC-backed companies to prematurely push for an acquisition or IPO. Some late-stage companies are even facilitating periodic secondary market liquidity events for employees via buybacks or third-party tender offers. We believe that partial exits for employees are an especially powerful growth driver for the volume of direct secondaries in the near term.

Additional sellers in the direct secondary market include GPs and founders. There recently have been some high-profile GP direct secondary deals, including Uber reportedly considering somewhere between $2 billion and $10 billion of secondary shares stapled onto a new primary round, as well as the announcement of Goldman Sachs Investment Partners' sale of $75 million of Spotify shares. On a similar note, a term sheet from a potential primary investment by WeWork in an undisclosed company included the secondary purchase of a portion of the founders' equity.

The seller composition in direct secondaries means that investors can often access equity securities situated throughout the cap table, not just the piece owned by institutional investors. Direct secondaries also allow investors to gain access to high-growth and emerging technology companies that they were not able to access in the primary markets. This was evident in late 2010, when auctions on secondary brokerage sites like Secondmarket and Sharespost sent valuations skyrocketing for then-private companies such as Facebook and Groupon.

It is difficult to generalize about the risk and return profiles of direct secondary transactions, as each individual company's shares have their own unique characteristics that must be weighed fully by the investor. Much like purchasing a single stock, investments in direct secondaries carry significant amounts of company-specific, or unsystematic, risk. The relatively nascent nature of the market means that investors must rely on a relatively small number of brokerages that list a limited number of shares. This inherently supply constrained and illiquid market can cause unwanted volatility—a risk that investors may not willing to take.

Obstacles

Many roadblocks in direct secondary transactions arise purely because of the opacity and scarcity of information on the companies, but there are many other legal and regulatory issues too. From a legal standpoint, agreements to buy preferred shares directly from GPs tend to present extra complexity; if not addressed correctly, right-of-first-refusal clauses in a stockholder agreement can completely derail a transaction. Furthermore, stockholder agreements can contain transfer restrictions that can prevent a transaction opportunity. For this reason, it would be prudent when initiating a direct secondary transaction to consider other major investors, their motivations and which rights they might exercise.

Due diligence processes are a significant undertaking for direct secondary transactions, usually requiring potential investors to sign non-disclosure agreements prior to receiving any company information. This highlights how key the relationship is with the company whose shares the transaction centers on in a GP direct secondary transaction. These deals often require company or shareholder consent to sell the shares, as well as outside legal opinions on the legality of the sale under securities and tax law. The company also needs to consider the effect of changing ownership of preferred shares and which rights (e.g., board seats, liquidation preference) this new investor may be entitled to. It is also worth mentioning that investing in GP direct secondaries usually requires large cash reserves to both purchase the position and to participate in follow-on rounds to prevent future dilution.

Broader participation has been hindered by the fact that there is only a handful of brokers devoted to the direct secondary market. This can be attributed to the many structural difficulties secondary venture marketplaces must overcome, most noticeably the tradeoffs in costs and benefits exchanges make to both encourage increased investor participation and more broker-dealers to make markets. Also, some earlier venture exchanges struggled as successful companies that were listed would eventually graduate to public markets or get acquired, resulting in a reverse survivorship bias that precipitated the misconception that the exchange was populated only by poor-performing companies.

Additionally, this market has struggled with the stigma that sellers have stopped supporting or don’t believe in the company. We are starting to see these perceptions relax, as frequently, with regard to older VC-backed companies involved in these transactions, the sellers are long-term employees or investors whose initial investment generated above-average returns.

Outlook

Given the nature of the primary venture market, we expect the venture direct secondary market to continue evolving and to become a more prominent presence within the scope of venture capital. Despite some headwinds, volumes continue to grow as VC-backed companies and their investors increasingly see the benefits provided by the direct secondary market. In general, the overall growth of venture capital as an asset class contributes directly to the market opportunity in secondaries. The years since 2013 have seen an explosion of funds flowing into VC, a growth pattern that has been paralleled by the direct secondary market’s expansion. Another overarching theme is the need for liquidity optionality, especially for employees at VC-backed companies. Additionally, average times to exit continue to extend, while record capital overhang levels don’t signal any lack of available capital in the coming years. This means late-stage companies will continue to be able to operate efficiently and fund growth in the private market.

Under the so-called piggyback exception of Rule 15c2-11(f)(3), a broker-dealer may publish quotations on a security in an interdealer quotation system, without complying with such information gathering requirements required by the Rule, if the security has been quoted in the same system on at least 12 of the previous 30 calendar days, with no more than four business days in succession without a quotation. A broker-dealer can "piggyback" on either its own or other broker-dealers' previously published quotations.

Exchanges in the direct secondary venture marketplace have the difficult task of changing the paradigm of venture capital investing. A drastic shift toward a more open dissemination of information would blur the traditional lines between public and private securities; however, the secretive nature of venture investments—not to mention the restrictions presented by NDAs—present significant hurdles. Exchanges are also tasked with finding the previously mentioned balance between protecting investor rights and broker-dealer incentives, all while controlling listing standards to minimize fraud and to encourage more companies to list. If standards can be agreed upon and upheld consistently, regulators must cooperate to allow the market to flourish.

Regulations will need to play a role as well if the direct secondary market is meant to reach an optimal level of functionality for the venture capital market. Reforms to Exchange Act Rule 15c2-11 (f)(3) (referred to as the "piggyback exception"), for example, could be made to benefit investor protection and education in over-the-counter (OTC) markets on unlisted securities. One specific step would be to require each broker-dealer that quotes a security to provide more information on the securities to investors and to hold up-to-date information on the issuer. Currently only the first to quote the security must hold this information, which can make it very difficult for investors to obtain. Some of these proposed amendments have been brought up in the past but were never finalized. If some major hurdles can be overcome by exchanges and regulation, we would expect a period of even more rampant growth for the direct secondary market.