Inside the Growing Secondary Market for Venture Capital Assets

By Dan Burstein and Sam Schwerin
Managing Partners,
Millennium Technology Value Partners, L.P.

For the last decade, secondary market activity involving all types of private equity investments has been a booming and increasingly efficient aspect of the far larger overall private equity market. Total secondary private equity transactions have grown 14-fold over the last ten years, from approximately $600 million in 1998 to well over $8 billion in 2007. Indeed, secondary private equity investing grew at an even faster rate than the unprecedented and explosive growth of total private equity assets under management during the same time period.

This megatrend of growing secondary investment was originally fueled by the business of trading limited partnership or limited liability company interests (which we will refer to in this article as Fund Interests), in the largest and best-known private equity funds. But as the market has grown and developed, secondary investing has expanded its scope significantly and become more global. Today there are active markets for Fund Interests of almost any size and in almost any private equity investment sector—large-scale corporate private equity funds, hedge funds, real estate funds, geography-specific funds, distressed securities funds, venture capital funds, etc. The leading secondary funds in 2008—such as Lexington Partners, Coller Capital, HarbourVest Partners, and Landmark Partners—with billions of dollars dedicated to secondary investing, are now bigger than the leading primary private equity funds of the 1990s. A recent report from Probitas Partners indicates that over $15 billion was raised in 2007 alone for funds specialized in secondary investing.

The substantial increase in the number of active participants and ancillary services involved in today's secondary market reflects its growing efficiency and maturity. Today there are private auction exchanges, investment banking firms and other intermediaries specializing in secondary transactions, secondary funds-of-funds, and even publicly-listed secondary funds, such as Lehman Brothers Private Equity Partners, which trades on the Amsterdam Exchange.

One of the newer frontiers of secondary market activity is what we would term "direct secondary investing," meaning buying and selling securities in individual private companies, rather than in bulk portfolios of Fund Interests. Direct secondary investing in the larger private equity-backed situations began to take off in the early part of this decade. The 2007 *DowJones Guide to the Secondary Market* lists more than 20 firms and funds that are active in the direct secondary market. Particularly new and noteworthy is direct trading in secondaries in smaller venture capital-backed situations. This is an area in which our firm has developed a specialty. Since 2002, we have made well over 100 direct secondary investments in venture capital-backed technology companies, with deal sizes ranging from under $1 million to more than $15 million.

When it comes to direct secondary investing in venture capital assets, the market remains comparatively underdeveloped. With approximately $300 billion of assets under venture capital management in the United States today—and an increasing amount of venture investment flooding into global markets like China, India, and Israel—it is only a matter of time before this market gains some of the sophistication and maturity of today's secondary market for Fund Interests and other secondary market sectors. *Indeed, we believe that over the next few years, the market for direct secondary venture capital assets will become a multibillion dollar annual market*.

The direct secondary market could become larger in size than the market for Fund Interests. The ultimate size of the Fund Interests marketplace is limited to the value of institutional fund investments in venture-backed companies. The direct secondary market, on the other hand, includes the value of all those same institutional fund investments, but also includes the ability to access much larger enterprise values derived by aggregating all interests of all stakeholders—i.e., founders, employees, common stock holders, option holders, venture debt lenders, strategic partners, etc. (In many venture-backed companies, for example, institutional investors own about half the equity in the company, while founders, management, and employees own the other half. Direct secondary buyers can invest in either or both halves of the capital structure, whereas the pieces that would typically show up in the Fund Interests market would be limited to the equity owned by the institutional investors). The overall growth of direct secondary trading will be driven fundamentally by the need for liquidity shared by all constituents in the venture capital marketplace. And it will be amplified in many cases by the increase that we are now witnessing in the creativity and sophistication of both buyers and sellers.

When sellers turn to the secondary market, they do so for many reasons. Among some of the more frequently cited are these:

- A need to generate cash liquidity from illiquid assets.
- A desire to reduce expenses and administrative burden associated with managing non-core assets (or assets that have become non-core).
- A plan to reduce, eliminate or meet regulatory, accounting, and compliance requirements.
- Optimizing tax benefits, particularly accelerating the write-off of underperforming investments in operating companies that are still operating.
- Alleviating the need to allocate follow-on capital for existing investments.
- Reallocating funds to new areas of strategic value.
- Rebalancing and diversifying portfolio allocations or relieving the concentration of value/net worth.
- Personal needs on the part of individual founder/executive sellers—from starting a new business, to buying a home, to managing the distribution of assets in a divorce.

A confluence of factors is currently accelerating the growth of the direct secondary market. First and foremost, especially right now in the midst of the unprecedented 2008 credit market correction, is the substantial need for liquidity on the part of many different kinds of investors in venture capital assets. Over the last several years, hedge funds, private equity funds, and even public mutual funds made investments in private, illiquid venture capital-backed companies as these investors tried to expand their portfolios in the search for out-sized returns. Now that some of these funds are facing market meltdowns, aberrational pricing, and liquidity squeezes in the areas of their core competency, their venture capital portfolios are seen as a luxury more than a necessity.

Generating liquidity from illiquid venture assets can be a useful means of repairing, reallocating, or increasing capital bases. However, achieving liquidity can be challenging because of all the quirks often found in venture capital investments, including that they are often hard to value and may:

- lack externally available legal and financial information;
- need reserves for follow-on investments in order to protect value;
- be subject to unique transfer restrictions;
- be difficult to leverage;

- face technology and market acceptance risks not typical of larger, more mature operating company assets.

Nevertheless, given the vast demand for liquidity building up throughout the financial system, we expect sellers and buyers of these assets will find new ways to identify each other and implement transactions at unprecedented levels in the coming months.

We believe that the secondary venture capital marketplace is several years behind the pattern previously established by the larger-scale private equity market, but demonstrably following similar trend lines: First, the asset class itself booms, vastly expanding assets under management, number of funds, number of investors, etc. Second, a significant secondary market soon develops for Fund Interests. Finally, in the next phase on the maturation curve, a market blossoms for secondary directs.

Consider some of the key dimensions and developments in the venture capital marketplace today:

- Assets under management in the U.S. venture capital market are now more than $300 billion.
- Venture capital assets under management are mushrooming in international markets as well, with estimates ranging upwards from $100 billion, meaning that total global venture assets under management are now over $400 billion.
- Over the last decade, venture capital dollars went into more than 30,000 financing rounds for companies that never achieved liquidity for their investors through an IPO or M&A exit.
- 2007 alone saw nearly $30 billion worth of new venture capital investments made into about 3,000 venture-type companies, with many investors believing they were investing into a rapidly opening and even booming IPO market for technology companies.
- To the degree the IPO window was opening, it is now appears to be closing, based on the generally dismal performance of 2007 new issues, the increasing costs involved in attaining compliance under the Sarbanes-Oxley Act of 2002 and other regulatory standards, and diminished investor appetite for risk. Thus far in 2008, the list of IPOs postponed or pulled completely has been growing daily and the prospects for investor liquidity via the IPO market are drying up.

- Non-traditional venture capital investors, primarily hedge funds and larger-scale private equity funds, were significant participants in much of the new venture investing that was done over the last two years. These funds, in particular, are the investment entities facing an unprecedented need to deleverage and gain access to liquidity as a result of the overall global credit crisis.
- With a rising tsunami of credit market problems—margin calls, paralyzed auction rate markets, defaulting loan portfolios, home foreclosures and collapsing values in subprime and even prime portfolios—numerous kinds and classes of investors will be able to make use of liquidity from their venture capital investments. *And the reality is that, compared to the credit markets, the secondary venture capital asset market is open and functional.*

Most $400 billion global asset classes are large enough to provide the basis for the genesis of secondary markets, dedicated secondary funds, derivative products, private exchanges, and expert intermediaries. For many historic reasons, venture capital has been slower to generate these secondary market specialties, but is clearly now following the patterns established a few years earlier by other alternative asset classes. Add to the sheer size of the market the additional factors cited above, and we begin to see the emergence of the following equation: *A $400 billion global asset class, invested in 30,000 or more underlying assets, with the most recent inflow of dollars having come from the very investors most in need of liquidity today… yielding a significant increase in secondary market transactions in 2008 and for the next two or three years of the present cycle to follow.* Indeed, if only two to three percent of the total volume of invested capital were to change hands in secondary transactions in a given year (a very modest "churn" factor for most financial markets), we can envision a direct secondary market of $6 billion to $12 billion on an annual basis. This forecast for what amounts to a 10-fold expansion in the secondary direct market follows the actual 14-fold growth in the secondary market for Fund Interests experienced in the last cycle.

We believe that the current demand for liquidity will serve as a mother of invention helping to expand the market and make it more efficient. But the need for liquidity is a *constant*. It is not just a set of crisis conditions that causes owners of venture capital assets to want to sell them. In fact, there are many reasons for investors to participate in a more liquid marketplace *all the time*. The current market distress will be a catalyst that brings large dollar volumes to the secondary market, just as the post-2001 tech bubble environment touched off a significant increase in secondary market growth. But the fundamental reality is that *investors need liquidity for their venture capital assets for a multiplicity of reasons.*

Let's take a closer look at some of the long-term drivers of secondary market activity:

<u>Longer holding periods</u>. The median holding period for a venture capital investment (i.e., the time between initial investment and an IPO or M&A exit) has recently risen to more than seven years, an all-time high. This median seven-year statistic represents a 40% increase over the median of a decade ago. (Moreover, seven years is a success-biased number, based only on the venture-backed companies that actually obtained exits, and excludes all of the companies that dropped by the wayside or floundered indefinitely). Seven years with no liquidity is too long for many professional investors. In those intervening seven years, corporate/strategic investors often find that their business development goals change and are no longer synergistic with some of their portfolio companies. Mutual funds and hedge funds may find that if they have not achieved big wins on these investments within the first few years, they lack the patient capital resources to continue investing in financing round after financing round, nor do they have the human resources to be a value-added investor in the labor-intensive art of nurturing private technology companies to successful outcomes.

A typical venture capital partnership is organized around a 10-year lifespan. During this ten year period many internal and external forces may intervene that can result in investors desiring earlier cash distributions. The vicissitudes of time and financial markets can also suggest critical changes in strategy or technology or sector focus are needed. For these reasons, investors—as well as venture capital fund managers themselves—are increasingly interested in tapping the secondary market for partial or complete exits earlier than seven years into an investment.

<u>Incentivizing management.</u> Most venture-backed companies pay their management teams comparatively modest cash compensation, incentivizing founders and other executives with the tantalizing vision of how much the common stock and options they hold may be worth in the event of a successful IPO or sale of the business. This is, no doubt, a virtuous premise that has tended to align interests between investors and managers reasonably well. But with a seven-year hold period becoming typical (and usually even longer for the founders, who often started their companies a year or two before taking on first venture investments), and with serial entrepreneurs starting companies later in life when they may have mortgages and other family-related costs to worry about, the secondary market is

becoming a useful tool that allows management to obtain earlier liquidity for their holdings. Secondary liquidity programs offered to senior management and employees also serve to reduce the impact of inflation in compensation programs, while increasing the team's motivation by converting a small portion of options to cash in the bank. Also, in an environment where regulators have increasingly targeted private technology companies with option pricing scrutiny, secondary buyers can serve as a sophisticated "reference market" for private company valuations and 409A option pricing (with the added benefit of helping employees to realize the value of option awards). Furthermore, in cases where founders and early employees part ways with their company, secondary sales can provide those individuals with capital to support their goals—such as funding a new startup—while facilitating solutions to the problems that sometimes arise after an influential employee has left the company.

<u>More efficient capital structures, better alignment of interests.</u> Secondary transactions can also work well as tools to streamline capital structures prior to an IPO by buying the interests of smaller shareholders and rendering the cap table more efficient in the eyes of underwriters and institutional investors. Moreover, investors and management teams are increasingly viewing the secondary market as a method to provide liquidity to help solve a wide range of issues, from employee motivation to litigation and severance situations. In several recent transactions we have found ourselves building a synthetic severance program designed to facilitate a management transition or negotiating to remove litigious founders or employees. In all these situations, solutions can be funded by the secondary purchase of shares, rather than through use of valuable company cash-on-hand. As companies have come to understand the increased flexibility the secondary market provides them, they have come to look more favorably on waiving ROFRs (Rights of First Refusal) and facilitating the process of dealing with the various transfer restrictions in order to bring new value-adding secondary investors into the capital structure.

<u>Retaining and salvaging value—before it is too late.</u> Venture assets are among the rare financial investments that can become worthless, even in the absence of a bankruptcy, and even when the underlying company ends up with a successful outcome. At one point in the history of venture capital, the earliest investors reaped the biggest rewards. But in recent years, that principle has almost been inverted. Additional rounds of financings, cramdowns, pay-to-plays, conversion of investors' senior preferred stock to junior common stock—these are all part of the daily reality of venture investing. From angels who never imagined they would have to backstop their investments with additional cash to strategic investors whose investment allocations have changed, certain investors have been forced to

sit by and watch their investments lose value—not through malevolence or malfeasance, but by the dilution of additional fundraising rounds they can't, won't, or don't participate in. Today, the secondary market may offer investors facing this impending dilemma a way to recover some value. By selling to secondary market buyers before the cramdown or the pay-to-play takes place, the buyer can sometimes ascribe a higher price to the asset, because the buyer is able to "play" the shares in the next financing, whereas the seller was not going to be able to do so.

<u>Breaking out of the "Hotel California" syndrome.</u> Even when venture investments don't become significantly diluted or devalued, they are often too similar to the situation described in the famous Eagles' song, Hotel California, where you can check in but you can never leave. By offering liquidity strategies to investors, the secondary market allows them an opportunity to adjust risk and return, achieve partial liquidity on some of their investments in advance of actual realization events, and otherwise create better management of the capital allocated to venture assets in a portfolio. These steps help "fix" a major challenge inherent in swinging for the fences in traditional venture investing, where investments are usually forced into binary outcomes—either they are home runs or strike outs. By offering a market price and exit transaction at any stage (e.g., especially when the risk-return equation changes unexpectedly), the secondary market can help promote allocation to venture in the first place. In other words, if investors know there is a mechanism to correct for assumptions that have proven to be flawed without simply having to watch and wait until the asset becomes worthless, the underlying primary venture capital marketplace should benefit as well.

Buy-side trends fluctuate with market conditions. As the secondary market for venture capital assets expanded during 2005-7, and as general venture capital pricing trended upwards during that period, many secondary assets traded at a premium to their cost bases, and the number of funds doing direct secondary investing increased significantly. More recently, with public market comparables falling in value and certain sellers experiencing more pressure to achieve liquidity, secondary pricing has been declining.

One of the challenges of doing direct secondaries is that no two deals follow the exact same pricing parameters. In comparing two different companies with similar revenues, ebitda numbers, and growth trajectories, a founder's common stock in company X may be worth much more than another founder's stock in Company Y, simply because the common stock is behind much less preferred investor liquidation preference in Company X as compared to the situation in Company Y.

Supply-and-demand also plays a role: even with starkly negative financial market conditions prevailing in early 2008, some of the most attractive venture capital-backed companies have seen secondary transactions take place at premium pricing.

As secondary asset buyers, our firm tries to obtain compelling pricing. But we also recognize that appropriate and fair pricing is a necessary condition to maintaining long-term credibility in the business. Secondary deal structures can involve many aspects besides absolute price. We work with sellers to create shared upside scenarios above certain price points, earn-outs in the case of early liquidity events, asset-backed loan structures, and other features that make an overall transaction work well for all constituents. As a result, we believe that we have achieved a high seller satisfaction rate, with many sellers coming back to our firm for second and third transactions, and several companies working with our firm to create ongoing internal liquidity programs.

*****

For the legal community, the growth of the secondary market raises a number of interesting permutations on longstanding issues in private equity investing. Among the matters coming to the fore are the way transfer restrictions and Rights of First Refusal are written into investment agreements, the impact of recent SEC changes to Rule 144 and related issues, valuation policies driven by FAS 157 and more. Given that potentially significant corporate and securities law issues can arise in situations where restricted securities in private companies are bought, sold, or transferred, we expect the role of legal advisors with expertise on the issues of the secondary marketplace to grow considerably in the next few years.

We expect 2008 to be a record year for direct secondaries. The number and size of funds such as ours that focus some or all of their attention on the direct secondary market are growing. Much of the marketplace activity this year may be fueled by crisis and distress among those in the investor community that most urgently need liquidity. But we are simultaneously witnessing the maturation of this new marketplace, which draws its energy not from momentary crisis, but from consistent long-term trends. Corporate venture capital programs will always be subject to strategy shifts, designed to serve the needs of the larger company business plan. Departing founders will always need liquidity to start their next venture. Large-scale M&A events will always lead to pruning, restructuring, and selling off non-core assets. Bankruptcies will continue to occur in good times and bad, causing trustees to liquidate the venture capital portfolios within bankrupt companies. Certain investors will always discover too late that they had underestimated the follow-on capital needs or that they had misunderstood the technology or the business model. New global players will enter and exit.

At $400 billion, venture capital is beginning to resemble other large alternative asset classes more closely. As such, it should come as no surprise that, in a given year, managers of two or three percent of the total dollars under management would seek to re-allocate, restructure, get liquidity, or simply get out. The secondary market offers holders of direct venture assets new opportunities to achieve better, more efficient, and more productive management of their capital, new kinds of flexibility and targeted risk/reward ratios, and most of all, an opportunity to solve problems, correct assumptions, and recalibrate the outcomes of their portfolios. We believe that, as investors come to understand that they can create their own custom solutions for liquidity and rebalance risk/return ratios, they will become increasingly active participants in the direct secondary market.

About the Authors: Dan Burstein and Sam Schwerin are Managing Partners of Millennium Technology Value Partners, L.P. Mr. Schwerin has an extensive track record in large scale finance, private equity, and M&A, at investment firms including Salomon Brothers and The Blackstone Group. He has also helped found and manage several successful emerging growth companies in the last ten years. He holds an MBA from The Wharton School at the University of Pennsylvania. Mr. Burstein was Senior Advisor at The Blackstone Group for twelve years and has been making venture capital investments since 1983. He is also a bestselling author, having published a dozen books on global economics, new technology, and popular culture. Messrs. Schwerin and Burstein have completed more than 200 transactions with an aggregate value of more than $40 billion across many creative transaction formats.