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DEVELOPMENT OF THE SECONDARY MARKET AS NEW SOURCE OF LIQUIDITY FOR VENTURE CAPITAL AND PRIVATE EQUITY FUNDS

Abstract

The aim of this paper is to present secondary market as new source for liquidity for venture capital funds as IPO transactions tend to be less available for smaller companies. Changing trend on IPO market especially in US and Europe has brought the question on exit possibilities for venture capital funds as well as for their fundraising. Emerging of the secondary market helped the investor to maintain liquidity and enable small companies to retain financing form venture capital funds. This paper analyse the cause of the second market development and discusses its benefits.

Introduction

IPO is one of the most desirable exit pattern for venture capital funds. However as on the US and European stock exchanges number of venture capital backed IPO is decreasing. This brings the questions about liquidity for venture capital and private equity funds. This paper examines the possibility of liquidity for venture capital and private equity funds in its global environment after the global financial crisis and discusses secondary market as source of liquidity for venture capital funds. It also gives as a little information on Poland as it represents the most developed venture capital and private equity market

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in Central and Eastern Europe. It is also one of most active leader across emerging markets in venture capital and private equity backed IPOs and it is also facing the decrease in IPO transactions which leads us to the liquidity question as those exits were far more profitable for Polish funds than other type of exits. This is also very important factor for fundraising as for venture capital funds they were reduced at the Polish market to zero in 2012.

Initial Public Offering as a source of liquidity for venture capital and private equity funds

Venture capital industry as asset class is illiquid by nature and thus indeed to be long-term investment for investors with 10-12 year horizon. Successful Initial Public Offering is still one of the most important drivers for innovative entrepreneurs that start their own companies. The IPO is also crucial for venture capitalist that invest in this entrepreneurs, since it provides them with opportunity to exit their investment, and at the same time, realize strong positive returns. IPO make the venture capital industry tick and it is important factor in its investment cycle. This cycle typically starts with the creation of funds that rise capital from both institutional and private investors that are interested in backing innovative start-up companies. The venture capital funds select promising firms, which they support by contributing money and services that these companies need to reach next stage in their development. This continues until the moment that the VC funds decide to exit their portfolio companies. A significant part of the returns are then distributed back to the initial investors, enabling the restart of a new venture capital cycle. In these sequence of events IPO is considered as essential to sustain a robust venture capital industry. Several other exit mechanism are available to achieve exits, including trade sales, secondary sales and buy-back. However it is widely accepted that VC funds and entrepreneurs have traditionally preferred IPO. Through this rout, venture capital funds usually stand to gain the most from liquidating their successful investments. At the same time, the founders of high growth companies are able to regain control from the venture capitalist over the firm's affairs following the completion of IPO. the venture capital secondary market is now over half the size of the primary market.

However it could be observed IPO market claim that the significant decline in the number of public offerings over the past few years has disrupted the traditional VC model it two respects:

- Reduction in the number of profitable exits led to lower overall returns for venture capital funds investors,
- A decrease in the number of listed technology firms disrupted the steady supply of innovative entrepreneurs.

The VC cycle is also considered by some to be irreversibly broken due to the slowdown of IPOs, one of its central components. This developments and situation has also called into question the primacy of the IPO as the exit strategy. In sluggish IPO market, venture capitalist have been able to successfully employ trade sales as their exit routs. Trade sale become the preferred exit option for many venture capital firms. Contrary to IPOs, trade sales offer immediate liquidity without lockup periods, costly disclosure requirements and obligations for venture capitalists to maintain board seats. Most importantly, the dominance of trade sales leads to a more sustainable VC cycle. Thanks to slowdown in numbers of IPO transactions and poor results of most of the funds new venture capital cycle must be brought up. It needed to be pointed that the longer exit horizon for the array of investors in high-growth firms has opened up a liquidity gap in the former cycle, making it more difficult to align the interests of these investors, who often wish to pursue different exit strategies. This development created space for the emergence of alternative liquidity providers, which arguably provided the venture capital industry with the opportunity to continue to operate smoothly, but differently. So venture capital funds found new way for liquidity and pre IPO trading of shares in private secondary market.

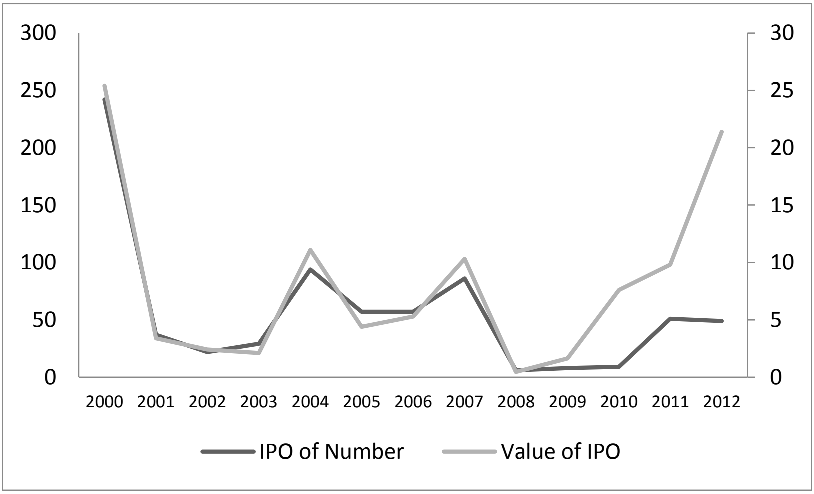

Figure 1. Value and number of IPO in US market in years 2000-2012
Lefs scale – IPO number, right scale value of IPO
Source: National Venture Capital Association Yearbooks 2000-2013

In US marekt we can observe very limited number of companies going for IPO in the period of 2008-2012, however their values are increasing. This means that IPO transaction is limited to companies that meet certain economic criteria. That suggest to investors that only few of portfolio companies may reach stock exchange and they need to look for new ways of liquidity for the rest of their portfolio companies. Venture capital is always a bit of a lottery. Facebook delivered over 35% of total venture capital exit value in 2012. It was an outlier, of course, but not without precedent, and in 2013 Twitter IPO will probably be 10%-20% of total exit value. This example show that over last years only successful companies have possibility to conduct highly valued IPO.

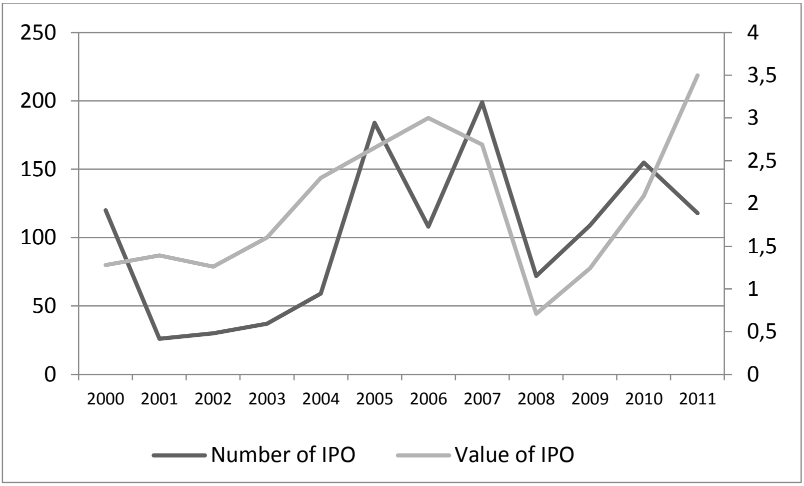

Figure 2. Value and number of IPO in European market in years 2000-2012

Lefs scale – IPO number, right scale value of IPO

Source: European Venture Capital Association Yearbooks 2000-2012.

European markets are quite similar to US market and we can observe decreasing numbers of IPO since 2008 and growing value of those transactions. That show that funds were waiting with their best portfolio companies for the good situation on stock exchanges and conducted IPO when valuation of the stocks were at high levels. Value of venture backed IPO on US and European markets support strong rally in equity markets which levels start to note record levels. Beside that only few numbers of venture capital firms may choose this way of exit.

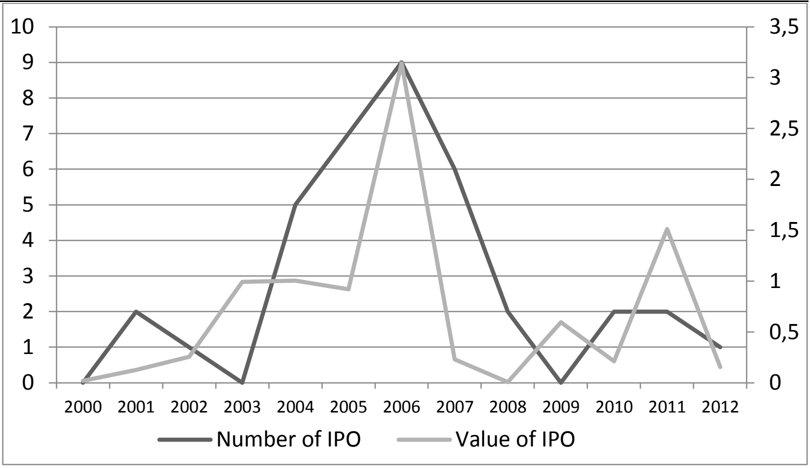

Figure 3. Value and number of IPO in Polish market in years 2000-2012

Lefs scale – IPO number, right scale value of IPO

Source: European Venture Capital Association Yearbooks 2000-2012.

On Warsaw Stock exchange it could be observed that since 2007 both number and value of venture capital backed IPO are decreasing and meet the levels of the pre-crisis period of 2001-2003. Very few companies go public and its value is also limited. That show that other liquidity ways must be found by venture capitalists. Secondary market is no develop in Poland as much as it is on other markets which leads to the question on liquidity for venture capital funds.

A new equilibrium in the venture capital exit

When we analyse divestments conducted by venture capitalist trade sale is the most important and even preferable exit vehicle. Even tough it could be observed that on the main markets value of IPO is rising but the number of trades stay at lower levels than those in 2006-2007. Recent data from US seems to indicate that a new equilibrium is emerging in which IPOs are available only to the best performing and most promising companies that have the ability to grow very quickly into world market leaders. Finally the best performing high-growth companies usually prefer to extend their reliance on private investment holding as long as possible before making the decision about going public. The new equilibrium in the exit market which is generally characterized by an increasing time to liquidity and high expected rate of return, has resulted in a decrease in the number of venture capital funds. Investors are founding in fewer, higher quality funds which are having highest quartile rate of return. Since IPO have become unavailable as an exit strategy for the majority of high-growth firms, VC have generally become more conservative and risk averse. This moved them towards the financing of already profitable later stage companies and companies founded by so-called serial entrepreneurs with considerable track record. In order to ensure steady flow of entrepreneurs and capital support, new liquidity options are required to support the VC cycle. The VC market adjusted to see these developments by rise of the secondary market.

The rise of alternative liquidity options – secondary market development

The availability of a secure exit strategy is of such importance that it can make or break the commitment of prospective investors to contribute human and capital resources to a fledging enterprise. This explains why the liquidity crisis of recent years is seen as a serious threat to the venture capital cycle. The lack of liquidity may also hamper the interest of new investors in the VC industry. Alternative liquidity options is playing an important role in the venture capital cycle. The biggest challenge for venture capital industry is to provide necessary incentives for the potential founders and key employees to engage in the new ventures. It is also important that exit through IPO allow the investors and entrepreneurs to regain control. In practice, this entails that besides capital and value-added services, the founders of VC backed companies acquired a call-option on future control, which could be exercised by demanding an IPO. They will be able to regain control in an IPO turned to be feasible. With the trade sale exit, the implicit contract is not available anymore. However, the extended exit horizon and its delayed cash out events potentially discourages entrepreneurship.

Taking to account problems faced by VC, founders and employees of start-up firms, it is fair to say that the rise of secondary market should be taken as a positive development for the VC industry. The growth of these venues during the most recent financial crisis is a sign that the market has provided a solution to the problem of declining liquidity in the VC cycle. The secondary market is relatively young, yet maturing segment of the overall venture capital marketplace. Its open to all investors including pension funds, family offices, foundations and high net worth individuals. The roots of the VC secondary markets date back to 1980s, however it took that market over two decades to develop from a niche market to a functional and active marketplace featuring meaningful and steady transaction volumes and numerous market participants. The period between 2006 and 2008 helped fuel recent growth in the secondary market as the financial crisis drove global banks and issuers to scale back their overall business and sell off position of their massive venture capital and private equity holdings.

While mature, the secondary market is still relatively young compared to venture capital primary market in terms of penetration, number of sellers and creativity in transactions. Various secondary buyers have evolved and become specialized along the line of size, geography, deal types, domain specialities and complexity. Secondary trading in in private company stock emerged to fill the liquidity gap. These marketplaces seek profit by helping investors to cash out of their illiquid positions in VC backed firms that could be years away from trade sale or an IPO.

In general, there are three types of portfolios for sale:

- Private Equity or Venture Capital Portfolios with a General Partner (GP)/Limited Partner (LP) structure,
- Corporate portfolios,
- Portfolios held by banks and insurance companies.

The vast majority of investment firms have a GP/LP structure. In principle, the general partners are managing the fund and its investments. The limited partners provide the necessary funding for the fund. While the LPs in such funds are mostly international investors, the GPs are usually based in the region, where the investments will be made. In a typical secondary transaction, a limited partner would sell both his existing investments in the fund as well as all future commitments towards the fund to a secondary investor.

Benefits of the secondary markets

It largely reduce blind pool risk and enhance visibility. Secondary market significantly reduce, and can eliminate the risk of entering a blind pool. This result in lower loss rates for secondary investments. In the initial years of a traditional primary venture capital investment, a fund will exhibit low or negative returns. This is normal but dragging effect on internal rate of return as management fees are changed on the basis of committed capital, and underperforming assets are usually identify early and consequently written off. Investing in fund as a secondary investor rather than a primary allows buying into the fund at a later stage, often directly into its distribution phase, which provides early positive cash flow, partially or entirely eliminating J-curve effect. Successfully transacting secondary fund position requires negotiation between the buyer and seller. Private negotiations permit the buyer to offer the exact price he is willing to pay for an interest. This often result in secondary asset acquisition at discounts to the reported net asset value. Secondary funds offer lower loss rate comparing to primary funds.

In venture capital portfolio context by acquiring secondary stake, an investor can accelerate his venture capital exposure much faster than with traditional primary commitments. From a portfolio perspective acquiring top-quartile secondary stake during first few years of a portfolio’s life cycle is an attractive, lower risk approach to building a venture capital portfolio, especially if venture capital budgets are limited. Adding secondary exposure to and existing venture capital portfolio provides backward vintage year diversification and distributions to the new investor will be noticed much earlier.

Conclusion

The recent changes in the exit phase of venture capital cycle may have detrimental effects on VC industry. The ability to exit an investment plays a crucial role in the operation of other parts of the VC cycle such as fundraising and investing by venture capital. Investment liquidity is also necessary to encourage start-up and attract the top talent necessary to grow these ventures. So we can observe growing need to develop private secondary markets that can facilitate pre-IPO trading in the shares of VC firms. Venture capital and private equity secondaries are therefore a highly attractive assets class. Research findings has shown that secondaries offer appealing advantages relative to primary investments such as higher average net IRR, minimal loss in net multiple, low levels of volatility, significantly lower chances of options and other considerations when constructing secondary portfolio. The way we can observe venture capital now is:

- Supply of primary venture capital, particularly early stage, has been cut by half or more at US European and Polish markets.
- The number of active firms is likewise down, for example in US market from almost 1,000 in 2000 to ~450 in 2007 to fewer than 300 in 2013. In Poland we have 45 registered funds and we observed only 29 investments in 2012. Most of them conducted by one fund.
- This sharp curtailment in the source of A and B round financing will feed through to fewer growth and secondary investment opportunities in three or four years, potentially leaving a lot of secondary fund capital chasing a limited number of deals.
- New fields for venture capital investment are opening up. Some say that consumer internet is fading: too much investment has flowed in and the powerful internet giants and there is too much capital there. But new sectors have opened up: health care, education and cyber-security.
- Exit opportunities are improving in 2013: the stock market is strong, corporations are ripe with cash. However many portfolio are not too mature to use those kind of exits. The new venture fields bring new acquirers to the table, breaking down the acquirer concentration that has depressed exit values and numbers.
- Venture funds are getting smaller, which means they can achieve strong returns for investors from realistic exits. Many smaller funds will be successful.

In the race for ever higher returns, some investors have over exposed themselves to private equity and venture capital commitments. Those commitments will be offered in the secondary market at an increasing rate. The gap between the book value/fair market value of assets for sale and the price that secondary investors are willing to pay, has narrowed over time. As a consequence, the number of secondary transactions is expected to increase significantly in the future. Sellers are either forced to sell or do so for strategic reasons. The secondary segment can be expected to be one of the most vibrant and active segments in the venture capital industry in the short- and mid-term.

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