The pertinence of VC secondaries

Before understanding venture capital (VC) secondaries, one has to grasp the private equity (PE) type. What PE secondaries put in place more than a decade ago shape how VC is going about it today.

Temps de lecture : minute

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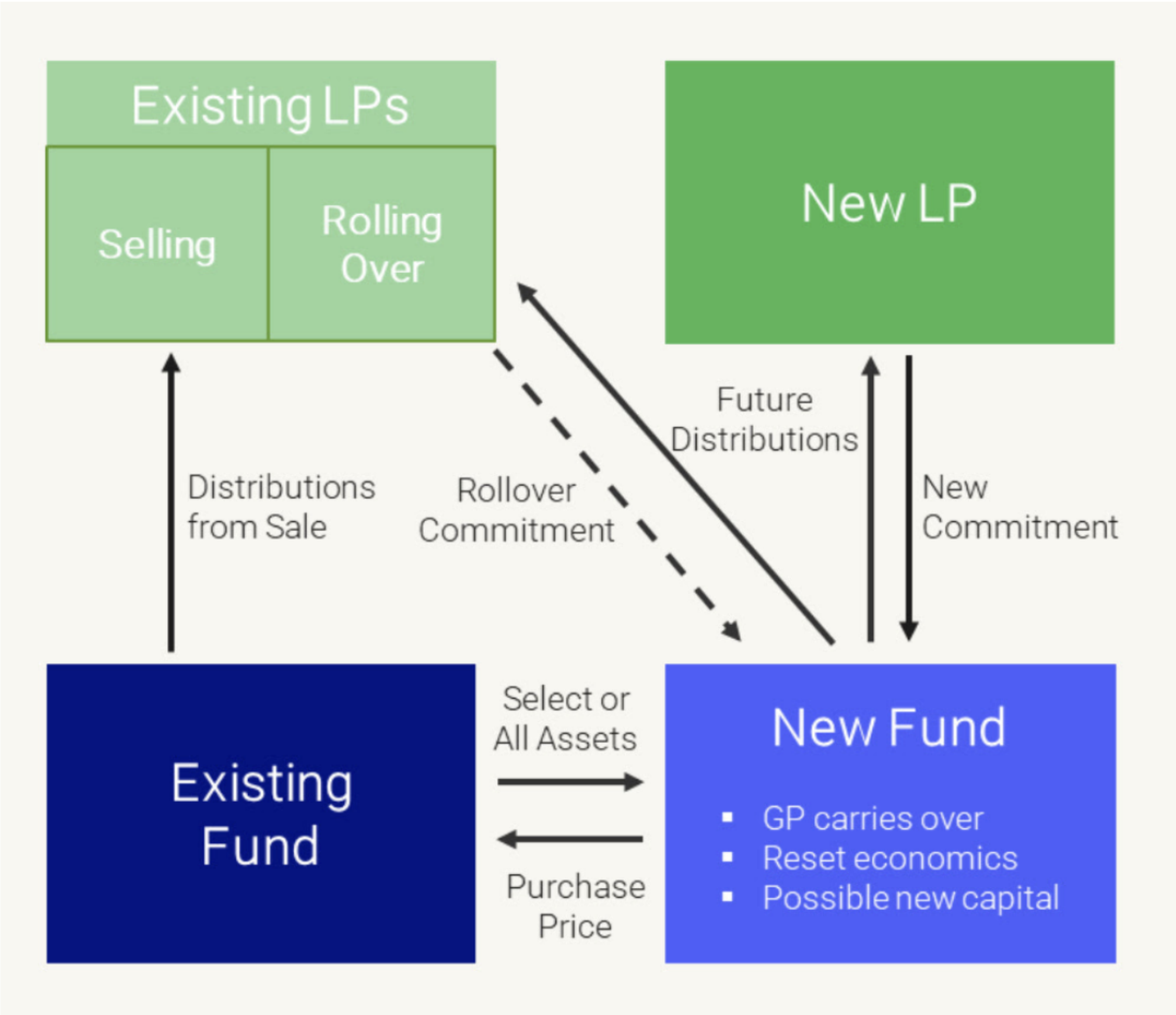
Following the 2008 financial crisis, underperforming PE general partners (*GP*) found themselves in a pickle. Their portfolio was underperforming and their limited partners (*LP*) were nervous about their return on investment. This made it difficult for GPs to raise money.

Some came up with an idea: carve out their portfolio's best performers into a new fund, a "continuation" fund, while selling the rest of the portfolio. Those sales returned some money to LPs. They could then either buy into the new continuation fund or call it a day. The GP, armed with a sexier fund and a sexier pitch, could also hunt for new LPs.

Soon enough, less subpar GPs figured this was a good idea and started doing it as well. This particular type of PE secondaries is known as "GP-led".

Other flavours exist. One of them is referred to as "LP stakes". In this scenario, one LP approaches another LP to buy out their stake in a particular fund. The GP doesn't necessarily need to be involved.

Another one is "net asset value (*NAV*)" financing. This is a lending play where the GP borrows money using their portfolio's value as collateral. In exchange, the lender gets preferential payout terms on the fund's upside. NAV financing is interesting because GPs retain equity, at the current price, while simultaneously boosting their portfolio. On the contrary, directly selling portfolio assets often implies a discount.



A GP-led "continuation" fund set-up (Industry Ventures)

Rinse and repeat

The difficulties the PE sector faced after 2008 is comparable with VC's current woes. Global VC raised and invested euphorically between 2020-2021 and is now suffering from a hang-over.

A mix of geopolitical tension and inflation have caused interest rates to rise. This has reduced LPs' propensity to invest: why take a risk on tech startups when you can lend out your money for a 5%+ interest rate? VCs are also realising that many of their 2021 investments were overvalued. Not only do they need to mark down valuations, but the sector's liquidity drought means exit options are scarce. They're having a hard time returning money, AKA distributed to paid-in capital (*DPI*), to their LPs.

So the story repeats, but with VC this time: portfolios are underperforming and LPs are nervous about their returns. This makes it harder for GPs to raise their following funds. Just as their PE predecessors, GPs might start considering secondaries.

The structures they can use resemble the PE ones. Namely, GP-led transactions, LP-stakes and NAV financing. VC introduces an extra secondary tool, namely the trading of private startups' shares.

Keep in mind that the VC secondaries market is still tiny. *Industry Ventures* posits that the total addressable market is around *$130B*, but the actual transaction volume is a fraction of that. Since these transactions are private, they aren't always publicised and thus hard to tally.

GP-led VC secondaries are still rare, so we won't dive into them. We will focus on the three others.

LP stakes

LP stakes refers to an investor buying the stake an existing LP has in a particular VC fund, becoming a replacing LP. The transaction happens between LPs, potentially without the GP being involved (in practice they tend to be and often initiate the transaction). For the acquirers, it's an interesting strategy to get into already hard-to-access performant VCs, build relationships with emerging GPs and gain exposure to promising portfolio companies.

The clever reader might think: “a VC LP shouldn’t want to sell its stake, because that’s not the VC model. It might mean they deem their stake to be deficient. So the market for VC LP-stake secondaries amounts to shares in underperforming VCs”.

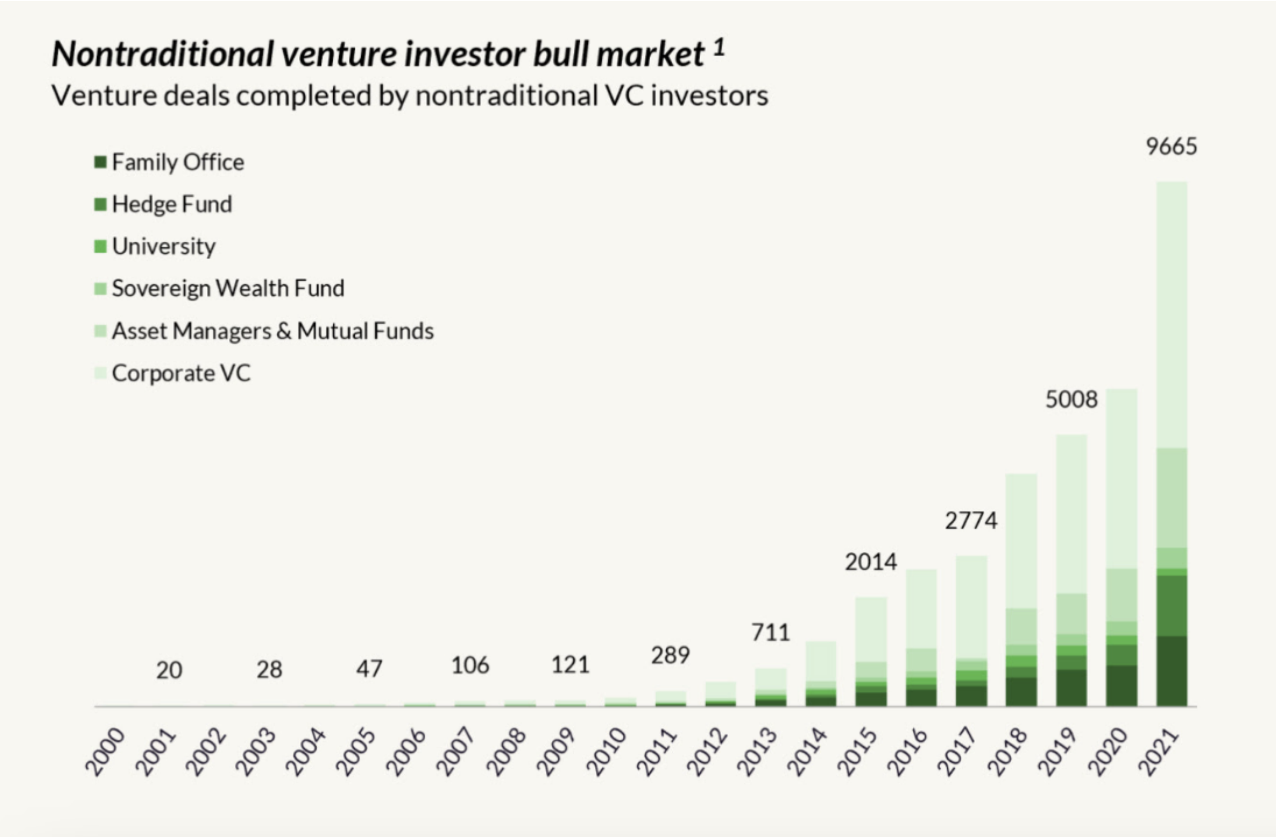
It’s not that simple.

LPs could want to offload their positions, even in good VCs, for several reasons. First, many LPs are institutional investors (pension funds, endowments, etc…) and increasingly struggle to see the pertinence of tech. Especially in light of enticing, juicy interest rates. Tech made sense in 2021 when lending money returned nothing, but that isn’t the case anymore. Between an tech-focused VC stake and high yield *T-Bills*, opting for the latter can make sense.

Another reason is the “*denominator effect*”. Think of it this way: you lead a pension fund and your strategy sets a 12% maximum allocation to private equities (of which VC is a part of). For some reason, the value of your public equities (such as your Apple stock) drops.

Assuming the value of your private equities stay the same, this mechanically means your % allocated to private equity rises, since it now represents a larger portion of your pie. If that % surpasses your maximum allocation threshold, you might have to offload some of it. Hence the need for an LP-stake manoeuver.

The increasing variety of VC LPs increases the variety of risk profiles. This means these LPs might have different exit strategies. This opens the door for alternatives to cash out on VC investments, and secondaries are one of them.



To be seen if the LP variety trend survives the current funding winter (Industry Ventures)

NAV financing

VC NAV financing deserves a closer look. As a reminder, NAV financing would be a GP using their portfolio's value as collateral to borrow money, while the lender gets privileged payout terms. This theoretically enables the GP to inject more money into their portfolio companies without diluting their equity.

Proposing NAV financing is an amusing way to gauge a GPs belief in their own portfolio. Intelligently structuring the proposal's math can reveal some nuggets.

As part of such deals, NAV lenders are generally paid back first, before the other LPs. A confident GP wouldn't mind, since they know there will be sufficient profits for everyone. A less confident GP would mind, as they'd like to avoid the meager profits being gobbled up by the NAV lender.

Obviously, this "test" is subjective and largely depends on other aspects of the proposed deal, but tinkering with it can be a useful yardstick.

Companies shares trading

A particularity VC secondaries have compared to PE ones is the participation of individuals. These can be angel investors, early employees, founders… any individual in possession of a VC-backed startup's shares. Like most equities, there's potential to trade them. This raises new quandaries, especially for founders.

The market for shares in private startups is *weird*. Since these companies aren't public, they aren't required to share any information publicly. This makes it difficult to determine the fair price of the startup's stock: how would you value a company, if the only info you have is its LinkedIn posts?

In the US, startups are required to conduct annual, independent *409A valuations* for that very reason, but the European regulation is still murky. Platforms facilitating these transactions such as *EquityZen* have developed their own tools for pricing shares, but even they *admit* that it is "both an art and a science".

This can be unsettling for founders. Their company is being valued "in the dark". If the valuation is too low, they might want to defend themselves to avoid spooking their own investors. But that could mean making some confidential numbers public.

Some founders are thus reluctant to let their startup's shares trade. Why does their opinion matter? Because founders can make it harder for employees to sell their shares, notably by withholding confidential information that one could use to adequately price their stock.

Founders of later-stage startups should make this process as smooth as possible. Indeed, their employees accepted lower salaries and longer working hours in exchange for equity. It's ethically wrong to block them from selling said equity, especially if the company is large but set on staying private. Even if it demands a bit more work.

Conclusion

Despite the market opportunity, VC secondaries are struggling to take off. Objectively, VC GPs might be willing to sell their mediocre performers but not their "*fund returners*". This mindset sits in sharp contrast to PE. VCs are betting it all on 1-2 startups to return the whole fund and more, while the rest of the portfolio is quasi-irrelevant. That changes secondary dynamics between PE and VC.

Demand on the buyer side is timid, too. Marquee LP-stakes actors tend to focus on predictable, PE companies and aren't as comfortable with unprofitable, risky tech companies. Potential buyers are also turned off by the scarcity of information on VC-backed companies.

One could imagine a world where VCs intertrade some of their own stakes, but that doesn't make much sense. VCs generally don't want their competitors to be privy to their portfolio's performance and if they really want to invest in a particular startup, they can just do so. That's their job after all.

This tepid environment is a shame because on-sale VC assets today are priced at tremendous discounts, especially compared to 4 years ago. Not all of them are good, but some of them could be gems. Cheap gems.

But working in VC secondaries feels like preaching in the desert: potential buyers don't comprehend the VC asset class and are enticed by the siren calls of high-interest rate lending. Adding insult to injury, what the market currently deems as “hot” (looking at you, Gen AI) is probably not on sale.

Nonetheless, VCs' liquidity issue remains. The many flavours of secondaries are all options to consider.

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