Private Secondary Markets: A Growing Investment Opportunity

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Tech companies want to stay private for longer, driving interest and liquidity in secondary markets.

Facebook changed the way many investors access the tech market. The company's rapid revenue growth, its ability to raise unprecedented amounts of private capital at attractive valuations and its ability to defer its IPO filing sparked a vibrant secondary market for its privately-held shares.

Facebook's emergence coincided with a persistently low-interest rate environment that allowed the best global private tech companies to access vast, readily-available pools of capital to follow Facebook's lead and remain private. The large supply of late-stage, privately held tech companies caused a proliferation of secondary transactions and, more broadly, the establishment of an organised, global secondary tech market that today encompasses most tech "unicorn" companies and many successful non-unicorns.

Secondary markets refer to direct transactions between selling and buying shareholders in late-stage private tech companies, be they individuals or

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institutions. The ability to purchase private shares from a shareholder in an existing business via a secondary transaction allows investors less experienced in the illiquid private tech markets to deploy capital across a wider range of late-stage opportunities with smaller investments per company to better manage their risk.

As the tech secondary transaction volume has grown, an increasing number of non-traditional tech investors – family offices and “ultra-high net-worth individuals” (UHNWIs) with limited access to primary tech opportunities who had historically eschewed private tech in favour of real estate and the public equity markets – have entered the market to gain access to a growing range of attractive, private tech names. Secondary transactions have enabled these investors to gain exposure to private companies typically reserved for first-tier angel and venture capital (VC) investors.

A budding market

The increasing depth of the secondary markets is being driven by three key trends.

First is the need for liquidity for founders, employees and angel investors, further amplified by the fact that even the most successful private tech companies have chosen to stay private for longer than before. Uber (founded in 2009) and Airbnb (founded in 2008) are still private; both are heavily transacted in the secondary markets.

Second, demand is growing from various forms of private (UHNWIs/family offices) and institutional wealth (funds/external asset managers, etc.) unable to access high-quality, late-stage tech in the primary markets. Historically, the way to access high-quality, mid-to-late-stage opportunities has been by committing capital as a limited partner (LP) to a top-tier Silicon Valley venture capital fund such as Sequoia Capital, Kleiner Perkins Caufield Byers or Andreessen Horowitz. Given how a handful of VC funds capture nearly all the unicorn (and non-unicorn) return, it is obvious that many different pools of both institutional and non-institutional capital are at a strategic disadvantage vis-à-vis traditional and long-established LPs in VC funds such as large Ivy League endowments or pension funds. Even those finite allocations available to new LPs at the best VC funds will tend to be offered to strategic, deep-pocketed players such as sovereign wealth funds, which can co-invest to support VC portfolio companies in need of huge capital injections to stay private longer.

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Third, there is a massive, fundamental shift in value capture from the public markets to private markets. Prior to the Google IPO, the best technology companies were going public earlier in their lifecycles, at lower revenues, and at lower valuations. This allowed public investors to capture a disproportionate amount of value relative to private investors. Beginning with the Google IPO, this trend has reversed dramatically (see table below), as the lion’s share of value has been captured in the private rather than public markets, as the recent Snap IPO.

Name	Year of IPO	Revenue @IPO*	Valuation @IPO*	Current Valuation	Prvt Return/Public Return****	
AirBnB (2008)	2018**	$1.5bn***		$30bn	3000x/	Pre-IPO Companies largest winners
Uber (2009)	2018**	$6.5bn***		$69bn	6900x/	
Snap (2011)	2017**	$300mn***	$24Bn	$37Bn	2300x/1.6x	
FB (2004)	2012	$3.7bn	$104bn	$344bn	11,400x/3.3x	
Goog (1998)	2004	$1.9bn	$28.1bn	$526bn	2,300x/25x	
AMZN (1994)	1997	$23mn	$430mn	$344bn	30x/1150x	Post-IPO investors largest winners
MS (1975)	1986	$293mn	$1.1bn	$455bn	50x/875x	
Apple (1976)	1980	$329mn	$1.5bn	$576bn	150x/385x	

* Inflation adjusted - in constant 2012 USD, ** Expected IPO year, *** 2016 Estimate, **** no inflation adjustment, no dilution

The secondary advantage

Not surprisingly, sophisticated investors have identified the secondary market as a key sourcing engine for the leading mid-to-late stage names that they are not able to access via the highly competitive and tightly controlled primary route.

Another key factor driving both deeper investor interest and activity in secondary tech markets is the growing realisation that they confer certain advantages to investors.

- Primary markets tend to be centralised, access to the best names is tightly controlled by founders/management teams and established, deep-pocketed investors (VCs/strategic investors/hedge funds/sovereign wealth funds, etc.), making it difficult for smaller/newer investors without a deep track record in the asset class to access the most attractive names.

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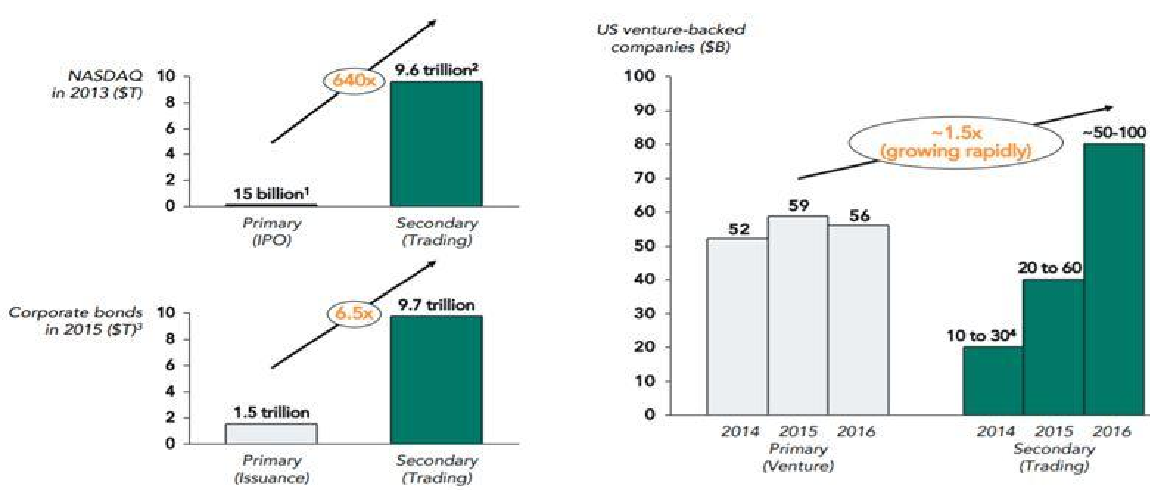
- Secondary markets are more decentralised and more “democratic”; companies try to control their cap tables but there are established, legal workarounds.
- Transactions are driven primarily by a desire for liquidity by existing shareholders; solvent buyers therefore have both more negotiating leverage and more time for diligence than is typical in primary markets.
- Secondary markets offer an efficient way to build diversified exposure to a basket of the best global tech companies as they provide the ability to transact in smaller bite-sizes than primary markets.
- These markets often offer compelling value not available in primary markets, for example via discounts to last round pricing. Typical discounts range between 5 percent and 15 percent for most.

Both the liquidity and depth of the private secondary tech markets is increasing rapidly. Our internal estimate for 2015 places the annual global secondary tech volume, including LP transfers, around US$45 billion to US$50 billion, or roughly ~0.75X of annual primary tech issuance. This nascent asset class seems poised to grow significantly over the next five to ten years, analogous to the global corporate bond markets, where secondary trade volume has grown to ~5X to 7X of primary volume as new technology increased transparency and accessibility to entirely new types of investors such as hedge funds, external asset managers and active institutional portfolio managers such as PIMCO. Over the last 12 months alone, we have noticed a threefold increase in both sell-side and buy-side trade inquiry and flows.



*Sources: 1. **Nasdaq** 2. **Statista** 3. **SIFMA** 4. **PWC 2015 MoneyTree report** 5. **WSJ, Things to Know About Pre-IPO Stocks***

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The way forward

The secondary markets may, in time, evolve to surpass primary investments as the preferred mode for alternative portfolios to take mid-to-late stage private tech exposure. There are, however, governance concerns that will need to be addressed, such as opacity and the dissemination of appropriate disclosure to private investors.

- While increasing liquidity is clearly positive, the boards of these companies will have to create new frameworks for engaging with this new (more fungible) class of investors.
- It is also worth pointing out that the private tech markets are illiquid and fast-changing, where individual company fortunes can change virtually overnight due to technology shifts, business model disruption or regulatory factors. Building a large, diversified portfolio of illiquid assets on the basis of limited information is therefore non-trivial and necessitates a sophisticated, long-term investment approach.

The future of the tech secondary markets may well be defined by the ability of technology to equip the growing tribe of neo-investors in this asset class with the tools to sustainably bridge the opacity and information asymmetry that has historically plagued this market.

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