AN OVERVIEW OF SECONDARY TRANSACTIONS

For Healthcare Companies

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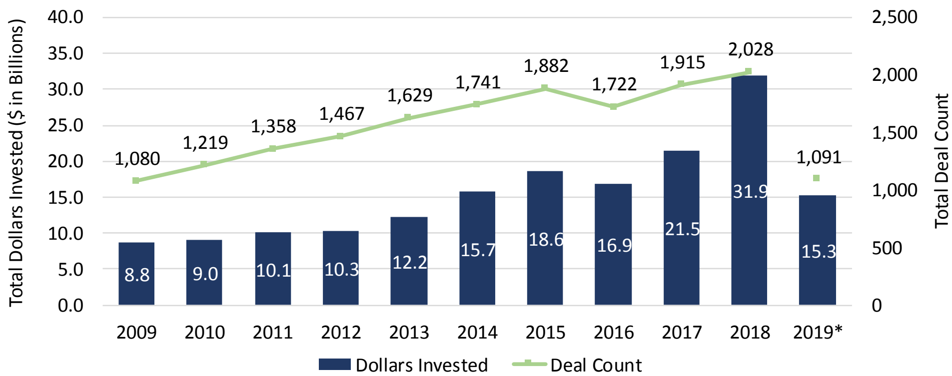
Introduction

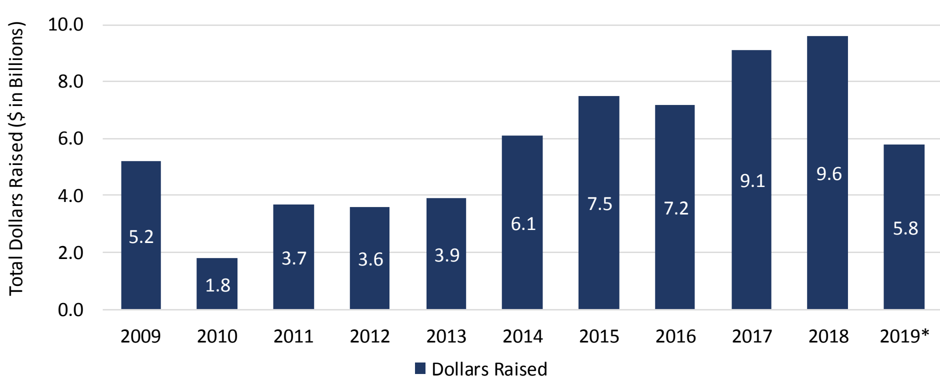
Venture capital investment in the healthcare sector reached an all-time high in 2018.[1] This was a continuation of a decade-long trend, which has seen $171 billion invested in over 17,000 healthcare deals since 2009. Alongside growing deal volume, healthcare companies are also raising larger private investment rounds. Approximately 60% of capital is now being invested in rounds in excess of $50 million.

Venture Capital Investment in Healthcare



The fundraising environment for private healthcare funds is also strong, having been bolstered by a multi-year bull market for biotech IPOs, a number of high-profile public acquisitions (Celgene, BTG, Covidien), and macroeconomic environment that has shifted investors towards risk assets.[2]

Healthcare Venture Capital Fundraising



Meanwhile, there remains a disparity between venture-backed investments and exits. Since 2009, only 1,615 healthcare companies have exited (approximately 10% of deals). While the IPO and M&A markets for biotech companies remain strong, the exit environment for other sub-sectors (including medical devices and diagnostics) has been varied over the past several years. Similar to investment patterns, venture-backed exits have become concentrated in fewer, but larger, deals. Additionally, some companies are electing to remain private for longer, based on the availability of venture funding and a desire to maximize value creation before accessing the public markets.

[1] Source: 2Q 2019 Pitchbook-NVCA Venture Monitor.
[2] Source: Silicon Valley Bank, Trends in Healthcare Investments and Exits 2019

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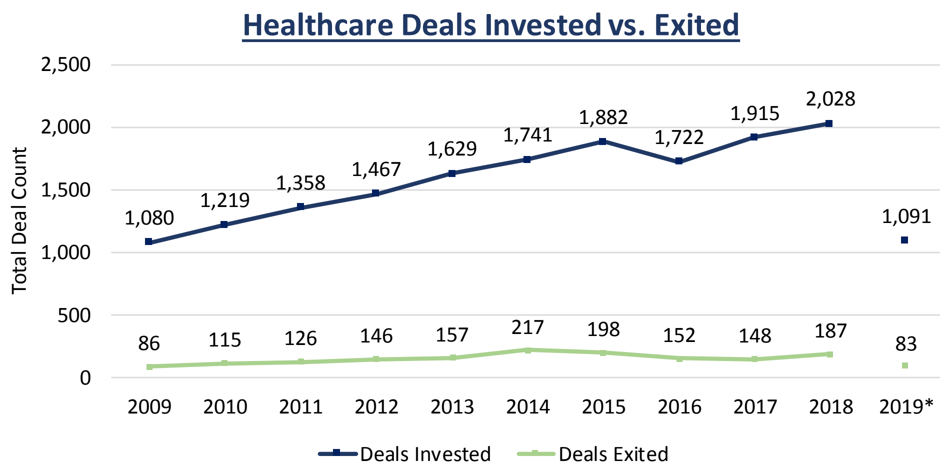

Due to these factors, the secondary market for private companies has grown and adapted alongside the broader venture-backed ecosystem. Private healthcare companies are increasingly turning to the secondary market to realign investor interests, manage capitalization tables, ensure the financing necessary for continued growth, and retain key employees.

Why Secondaries?

As a company grows and matures, it may face a number of challenges inherent to each stage of the company's life cycle. A secondary transaction may help to address a number of issues, including:

Realigning the Investor Syndicate. Within the existing syndicate, a company's investors may differ in their investment goals and timing expectations. Early investors, particularly non-institutional investors (i.e., angel groups or "friends and family"), may have a different time horizon for liquidity than later groups. Different types of investors (i.e., corporate venture funds, sovereign wealth funds, and family offices) may also have different underlying objectives and shifting motivations over time. Additionally, as the company evolves, it may diverge from certain investors' overarching investment strategies or specific investment theses. A secondary transaction can act as a "relief valve" to re-align investors and allow the company greater flexibility to optimize its exit timing and path.

Replacing "Tired" Investors and Ensure the Availability of Follow-On Financing. As companies raise multiple rounds of private financing, its capitalization table may become muddled with "tired," early investors. Members of the existing syndicate may vary in their ability or willingness to invest additional capital. Some investment funds may be constrained by their own fund limitations, such as impending end of fund life or lack of dry powder, while other investors may seek to invest further capital in order to maximize value creation. A committed secondary investor can not only satisfy the demands of these "tired" investors, but also "refresh" the investor syndicate, serving as a source of fresh capital to support the company's ongoing growth objectives.

Retaining and Motivating Employees. In recent years, restricted stock grants and stock options have become a larger component of employee compensation packages. Many employees may elect to work for early-stage companies in part for the equity upside. By allowing employees to sell small amounts of vested shares or options in secondary transactions, a company can not only reward its loyal employees, but also retain, motivate, and attract employees going forward.

Asset Diversification for Large Individual Holders

Large individual holders of a company's stock (such as founders or members of the management team) may have additional incentive to consider a secondary sale. For an individual whose personal net worth is highly concentrated in a private company, which may be illiquid and considered "high beta," it may be prudent to sell a minority position of their stock in order to diversify their personal holdings. Alternatively, an individual may have a need for personal liquidity; these situations are commonly necessitated by growing families, tuition, or healthcare expenses. The secondary market can be a logical solution in these scenarios.

Key Considerations

What are the Implications for the 409A Valuation? A common concern from companies regarding a secondary transaction is the impact to the 409A valuation. This impact is typically minimal, as a secondary transaction is just one of many factors the valuation firm may evaluate (others may include market comparables and discounted cash flow analysis), and unlike a primary investment round, the company is typically not directly involved in the deal.

There are several additional ways to mitigate the potential impact to the 409A valuation:

1. The company is not directly involved in repurchasing the shares, with the buyer and seller negotiating at "arms-length" from the company.
2. The secondary valuation is not disclosed to the company (the buyer and seller have entered into a confidentiality agreement, and the ROFR and co-sale provisions have been waived).
3. The transaction involves preferred shares, with different rights and privileges than common shares.
4. The transaction involves a relatively small volume of shares (i.e., less than 10% of fully diluted shares).

How to Manage Right of First Refusal (ROFR) and Right of Co-Sale (Co-Sale) Provisions? Private company stock is typically subject to transfer restrictions, the two most common of which are ROFR and co-sale. These provisions can complicate a secondary process, and in extreme cases, can even deter potential secondary buyers. An experienced and well-known secondary partner may be better positioned to work with the company's Board of Directors and existing investor syndicate to manage the impact of these provisions. Additionally, the company or selling individual may seek an upfront waiver of these rights from the major investors. The other investors may be willing to waive these rights if the secondary transaction provides certain benefits, such as resolving conflicts amongst the investor base or bringing a new, well-capitalized investor to support future follow-on needs.

What Type of Pricing / Valuation Can I Expect? Pricing for secondary shares is highly-specific. Generally, secondary buyers begin with a market value approach, performing an independent valuation of the company, accounting for its core business model, market dynamics, and IP, among other factors. This valuation then informs the pricing of various classes of securities in a company. Preferred shares are generally priced higher than common shares; pricing differences between share classes can be influenced by liquidation preferences, dividends, voting rights, and total liquidation preference relative to company valuation.

Secondary investors typically desire a reasonable level of information disclosure to evaluate a private company. Common pieces of requested information include the corporate presentation, financial statements, overview of key clinical/regulatory/commercial milestones, current capitalization table, and key corporate documents (including the Articles of Incorporation). Access to and support from the company's management may also support a robust diligence process. Greater information disclosure can lead to greater investor confidence, thereby maximizing the price that they are willing to pay.

Overview of Secondary Funds – What Makes a Good Secondary Partner?

Over the last ten years, the overall secondary market has grown in transaction volume as well as the number of firms serving this market. This growth is in response to macro-level factors in the venture market (increased investment with longer times to exit), along with the differing needs of private companies along various stages of the growth life cycle.

Meanwhile, the secondary market for healthcare companies remains relatively underserved due to the specialized nature of these companies, as well as the complex regulatory, reimbursement, and commercial environments. When considering a potential secondary process, healthcare companies should seek a dedicated partner who not only has the financial wherewithal to complete a transaction, but also the expertise to maximize both near-term and long-term value.

Healthcare expertise. Companies should evaluate a secondary buyer as a long-term partner, and as such, should prioritize a shareholder with specific sector expertise. It is important to have a partner who is well-versed in the unique regulatory, commercial, and legal dynamics of the healthcare sector. Initially, this specific expertise can contribute to a smoother due diligence process and optimized pricing for the secondary assets. Going forward, a knowledgeable investor is better positioned to support the company, both operationally and financially. Lastly, a healthcare-focused secondary investor is more likely to have relationships with the existing syndicate, facilitating a secondary process and promoting investor alignment.

Transaction experience. Secondary transactions are often more complex than primary investments, typically due to information asymmetries, legal considerations, and variety of potential deal structures and tax considerations. Additionally, it is important to consider the motivations and alignment of each key stakeholder group (major investors, management, board of directors, etc.). Each transaction is highly situation-specific, and it is important to have a partner who is well-versed in managing multiple facets of the secondary process and able to create a customized solution.

Dedicated Capital. A well-capitalized partner, with a dedicated capital pool, can ensure an expeditious closing, as well as provide future support for the company. Future support may include capital reserves to participate in follow-on financings, as well as the ability to execute subsequent secondary transactions for other shareholders (either institutional investors or employees). As the median time to exit for private companies remains high, a secondary partner can serve as an important source of ongoing expertise and support along the company's life cycle.

Revelation Partners

Revelation Partners is a dedicated secondary investor in the healthcare space, specializing in both capital and liquidity solutions to healthcare investors, companies, founders, and funds.

The firm has a 10-year track record dedicated to healthcare secondaries, and currently manages over $1.5 billion of committed capital.

About the Author

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