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TENDER OFFERS: A GUIDE FOR LATE-STAGE PRIVATE COMPANIES

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Introduction

Historically, there were very few options for private company shareholders to get liquidity prior to a company exit. Most shareholders, including founders and employees, expect to hold their shares until the company is acquired or completes an IPO. However, private companies now stay private longer, prompted by the availability of private capital, increasing private valuations, periods of public market volatility, and the desire to avoid certain regulatory and compliance requirements.

As such, the secondary market for private company shares has continued to grow in recent years. The total market for secondary transactions is expected to reach $100 billion in 2021.[1] These transactions often occur through direct negotiations between investors and shareholders, as well as on numerous platforms, such as Forge, Nasdaq Private Market, EquityBee, EquityZen, and OurCrowd, which have emerged to facilitate interactions, typically between retail buyers and individual sellers.

While these one-off secondary transactions are an effective way to provide liquidity to individual shareholders that may hold a small position, many companies elect to pursue formal tender processes, which give the company greater control over who owns its stock, while also providing liquidity at scale

The most common rationale for a tender process is to reward and incentivize a company's employees. Many early-stage companies grant equity-based compensation to align employees and create a culture of ownership. However, as companies remain private longer, employees may have fully vested options with no ability to realize liquidity for their shares, which may erode the value of the incentive. Through a tender, a company may provide liquidity to these employees, as well as other shareholder groups, including founders, angel investors, and early institutional investors.

The tender process is also an opportunity for a company to consolidate its shareholder base and introduce new investors who are well-aligned with the company's strategic and financial goals. These new investors may also support future fundraising efforts in a way that the tendering shareholders could not.

Deal Structures

A company may consider several different approaches and structures for a tender. These structures are not mutually exclusive, and may be utilized in different ways over time, based on the company's needs, shareholder demand, and investor interest.

Tender in Conjunction with Financing. A logical time to structure a secondary sale, whether for an individual or pool of investors (including employees), is in conjunction with a funding round. As the company's management team is actively engaging with investors for a primary round, they can leverage many of those same efforts to support the tender process (data room, diligence calls, customer references, etc.).

[1] Wall Street Journal, "Secondary Transactions on Pace to Reach $100 Billion This Year." November 1, 2021

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In This White Paper:

Common Goals of a Stock Tender:

- Reward long-term shareholders (including founders, employees, and early investors)
- Provide wealth diversification for employees
- Consolidate the shareholder base by removing certain smaller holders
- Introduce new shareholders who will support the company's financial and strategic objectives

Many investors, whether new or existing, may desire the option to purchase new preferred stock along with tendered shares. In the case of an oversubscribed financing round, an investor who could not get their full allocation of the primary round (or received a smaller allocation due to oversubscription) may be willing to increase their ownership percentage through a secondary purchase of common and early preferred stock.

The primary financing may present several other benefits for secondary investors and companies as well, including setting a current valuation for the company and reducing near-term financing risk.

Separately, another way for a tender offer to be conducted in conjunction with a financing is for investors to invest entirely in the new preferred series but specify that a certain allocation of the new round be used to repurchase shares from existing stockholders. The company, after repurchasing the shares, may then retire those shares or hold them in treasury.

Standalone Tender. A company may also conduct a tender process separate from a primary financing. Many companies choose to do this on a regular (typically annual) basis, with a focus on providing liquidity for employees and consolidating smaller shareholders on the cap table.

In addition to the benefit provided to the shareholders, the ongoing tender processes also serves to introduce new investors to the company. When the company raises a subsequent primary round, these new investors (including those who invested through the tenders) may serve as a source of additional capital.

Preferred Buyer Program. In order to further streamline the secondary process, a company may designate a preferred buyer for its secondary stock. A preferred buyer program may be informal (the company refers secondary interest to a small group of preferred funds) or formal (the company assigns a Right of First Refusal to selected secondary partners).

As part of a formal program, an investor may sign a term sheet or letter of intent with the company, designating a certain capacity to purchase stock and formulaic pricing (i.e., certain percentage discount to the last round, or predefined revenue multiple for company valuation).

There are many benefits to designating a preferred buyer for ongoing secondary purchases. The company can identify a trusted partner who is well-aligned with its strategic and financial objectives. With an increased level of familiarity, preferred buyers can act more quickly and with more certainty, while also allowing the company to limit information sharing with outside parties. Lastly, by designating a preferred buyer, the company can more effectively stay at an “arms-length,” minimizing the potential impact to the 409A valuation.

A preferred buyer program can be particularly helpful in an acquisition scenario. As many acquisitions are structured as cash and stock deals, the shareholders of the acquired company may desire near-term liquidity for the shares received in the transaction. A preferred buyer can facilitate this liquidity process, and, as a result, the acquisition itself, in effect serving as an outside source of cash for the company (by reducing the amount of cash the company needs to pay in the deal).

Tender Process

1. **Estimate Demand for Secondary Sale.** Before embarking on a tender process, a company should internally evaluate the shareholder demand for a secondary. This is influenced by a number of factors, such as the number of individual shareholders (including founder, employees, and institutional investors), age of company, and changes in valuation over time. The company should also determine the eligibility criteria for employees to participate in the tender (see “Key Considerations” below).

   The rough size of the tender will influence the type and number of potential buyers with whom the company may engage.

2. **Engage with Potential Secondary Buyers.** The company should engage with one or more potential secondary buyers to solicit interest for the tender. Similar to a primary investor, a secondary buyer will typically request diligence information, such as financials, cap table, and financing documents. Buyers may also request diligence calls with the management team, customers, and other related parties.

   The company should have a clear process for potential secondary partners, with equal access to information and defined timing for term sheets.

3. **Select / Sign Term Sheet with Buyers.** The company should select one or more partners based on a number of criteria, including but not limited to: 1) share price, 2) sector expertise, 3) future capital commitments, 4) long-term strategic and operational alignment.

   The buyer(s) will typically set a single price for each class of stock. Buyers may be flexible on the size of the tender or may set a hard limit. The term sheet may also contain certain representations and warranties, along with other precedent conditions, such as a Right of First Refusal waiver and/or waiver of other transfer restrictions.

4. **Administer the Tender through an Accredited Institution (If Applicable).** Depending on the number of eligible sellers, the company and buyer may choose to administer the tender through an accredited platform (i.e., Nasdaq Private Markets or Forge Global). If there many expected participants in the tender, this may facilitate the mechanics of share transfers and documentation.

5. **Notify Eligible Shareholders and Open the Selling Window.** Eligible participants are notified of the tender and provided with the necessary documentation, including:
   - An Offer to Purchase – outlines the key terms of the tender offer, including the total size, share price, shareholder eligibility, allocation methodology, and instructions on how to participate.
   - Letter of Transmittal – tendering shareholders will be required to complete and submit a letter of transmittal in order to sell shares in the tender.
   - Option Exercise Instructions – instructions on how to complete the contingent exercise and option exercise agreement (if option holders are allowed to participate through a contingent exercise).

   Per SEC regulations, a tender offer is typically required to be kept open for at least 20 days.

6. **Final Documentation and Closing.** After the selling window closes, buyer(s), seller(s), and the company will complete final documentation (including Stock Transfer Agreements), which enables the transfer of shares and cash.

   The transfer documents may include a general release of claims, which allow a company to ensure that past liability claims are released in exchange for liquidity.

Key Considerations

Tender Allocation and Eligibility Criteria. In tender offers for private company stock, the company will determine who can sell in the offer and how much they can sell. The eligibility criteria, which may be informed by estimated supply and demand, should define:

- Who can sell – companies may limit participation to current employees, employees with a certain tenure (i.e., greater than four years), or holders of certain classes of stock.
- How much can be sold – sellers may be allowed to tender up to a certain percentage of their holdings (i.e., 10 to 20%), or a maximum dollar amount, which allows employees to realize some liquidity, while not entirely "cashing out."
- Who gets priority – as many tenders are limited by the new investors' appetite, companies will need to establish an allocation methodology in case the tender offer is oversubscribed.

Effect on 409A. A secondary transaction may impact the company's 409A valuation, especially if the price paid for common stock is higher than the then applicable 409A value. There are several ways in which companies can mitigate the potential impact:

- The company should avoid being directly involved in repurchasing the shares, with the buyer and seller negotiating at "arms-length" from the company. The tax treatment may be less favorable when the purchaser is the company.
- The company should ensure the transaction involves a relatively small volume of shares (i.e., less than 10-20% of fully-diluted shares).

Before beginning the tender process, a company should conduct an analysis with its tax advisors and accountants regarding the potential impact to the 409A valuation, which may influence the structure of the transaction and certain eligibility criteria.

Pricing and Valuation. Pricing for secondary shares is highly-specific, and may be presented as a discount or premium to the company's last round. A secondary partner will typically utilize a market value approach, performing an independent valuation of the company, accounting for its core business model, market dynamics, and IP, among other factors. Pricing for different share classes (i.e., common vs. preferred) may differ based on liquidation preferences, dividends, and other shareholder rights. Once established, the same price will be offered to all shareholders within each individual share class.

The company can support the valuation process through information disclosure. Sharing key information with preferred partners can provide greater pricing clarity for all stakeholders. Common diligence requests include the corporate presentation, financial statements, overview of key regulatory and commercial milestones, current capitalization table, and key corporate documents. Access to information and alignment with the company's management team will maximize the price that investors are willing to pay.

Securities Law. Depending on the number of sellers and certain other factors (guidelines set forth in Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979); include active and widespread solicitation of shareholders and percentage of securities being solicited), the transaction may subject to Section 14E of the Securities Exchange Act of 1934. Under Section 14E, requirements include:

- Holding the offer open for at least 20 business days
- Not increasing or decreasing the percentage of the class of securities being sought or the consideration being offered unless the tender offer remains open for at an additional 10 business days from the date that such notice is given to shareholders
- Prompt payment of the consideration, or return of the tendered securities, upon termination or withdrawal of the tender offer
- Maintaining a net long position in the tendered security by the purchaser

Finding the Right Secondary Partner

When considering a tender process, companies should seek a dedicated partner with the sector expertise, transaction experience, and financial wherewithal to best align with the company's long-term objectives.

Sector expertise. Companies should evaluate a secondary buyer as a long-term partner, and as such, should prioritize a shareholder with relevant sector expertise. Initially, this specific expertise can contribute to a smoother due diligence process and optimized pricing for the secondary assets, based on an understanding of the specific regulatory, commercial, and legal dynamics issues faced by a company. Going forward, a knowledgeable investor is better positioned to support the company, both operationally and financially, as well as provide ongoing liquidity for shareholders (including future tender offers).

Transaction experience. Stock tenders are typically more complex than primary investments, given the unique structuring, legal, and tax considerations of the tender process. An experienced secondary partner should assist a company in evaluating the optimal timing and structure of a tender based on the company's unique needs and goals. Thus, it is crucial to have a partner who is highly-experienced and well-versed in managing the different facets of the overall tender process.

Additionally, the company may seek an investor with a strong track record of successfully closing transactions and investing additional follow-on capital as appropriate.

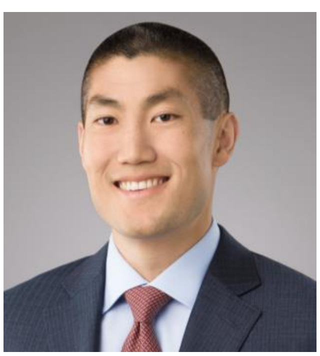
Dedicated Capital. A well-capitalized partner, with a dedicated capital pool, can ensure an expeditious closing, as well as provide future support for the company. Future support may include capital reserves to participate in follow-on financings, as well as the ability to execute subsequent secondary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

Overview of Revelation Partners

Revelation Partners is a dedicated secondary investor, providing flexible capital solutions to the healthcare ecosystem. We specialize in shareholder liquidity, GP solutions, and growth capital with a customized and long-term approach.

With a 13-year track record, deep sector expertise, an extensive industry network, and over $900 million of committed capital, Revelation Partners is a trusted partner to healthcare companies, investors, founders, and funds.

In March 2021, we closed Revelation Healthcare Partners Fund III at is hard cap of $350 million.



About the Author

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