THE VENTURE SECONDARY MARKET: A THIRTY-YEAR EVOLUTION AND SIX PREDICTIONS FOR THE FUTURE

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Distinguishing between the VC Secondary versus PE Secondary markets

Private equity, in its modern GP/LP form, began in the 1960s, but it wasn't until the early 1980s that names like KKR, Blackstone and Carlyle gained recognition. Around the same time, the first private equity ("PE") secondary funds were founded, with firms like Adams Street and Coller Capital leading the way into the early 2000s. By 2011, the PE secondary market grew 10x compared to the prior decade, reaching $24 billion in transaction volume, and by 2021, PE secondary transaction volume surpassed $130 billion.

Due to the opacity of the secondary markets, investors often mistakenly associate PE secondaries as being inclusive of venture capital ("VC") secondaries, although there is a distinct difference in the asset exposures, sellers, and investment firms engaged in these markets. These significant differences are not widely understood yet are critical to realize when investing in either secondary market.

PE secondaries involve transactions that have an underlying exposure to mature buyout-stage companies. PE secondary firms typically source deals from traditional private equity LPs and GPs, and often implement some degree of leverage in their strategy, whether it is on the underlying asset's balance sheet, applied at the fund level, or sometimes both. VC secondaries, on the other hand, involve transactions that have an underlying exposure to venture capital-backed companies. Given the diverse range of shareholders in most venture-backed companies, with no single-entity holds majority ownership, VC secondary investors source deals from a vast network of sellers including venture capital LPs and GPs, corporate venture capital groups (CVCs), cross-over investors (e.g., mutual funds, hedge funds, family offices), startup founders, employees and angel investors, angel networks, accelerator programs, etc. Interestingly, many sellers of VC secondaries do not hold buyout investments. Also, VC secondary firms, like their primary VC counterparts, tend not to use leverage at the fund level.

Thus, while some investors mistakenly believe the two markets overlap, there is a distinct difference in the types of company exposures being acquired, buyers and sellers in each market, and investment strategies used to generate returns.

The market for VC secondaries has historically been smaller than that of PE secondaries, simply given the fact that modern venture capital only gained institutional popularity over the past 20 years. But, given the exponential growth in primary commitments to the asset class over the last 10 years, and subsequent surge in the number of venture-backed unicorns, we believe that the VC secondary market could grow and become as large as the current PE secondary market. As explained in our latest blog post, with over $4.6 trillion of market value held by venture-backed unicorns[8], we expect the VC secondary market to surpass $130 billion by 2023.[5]

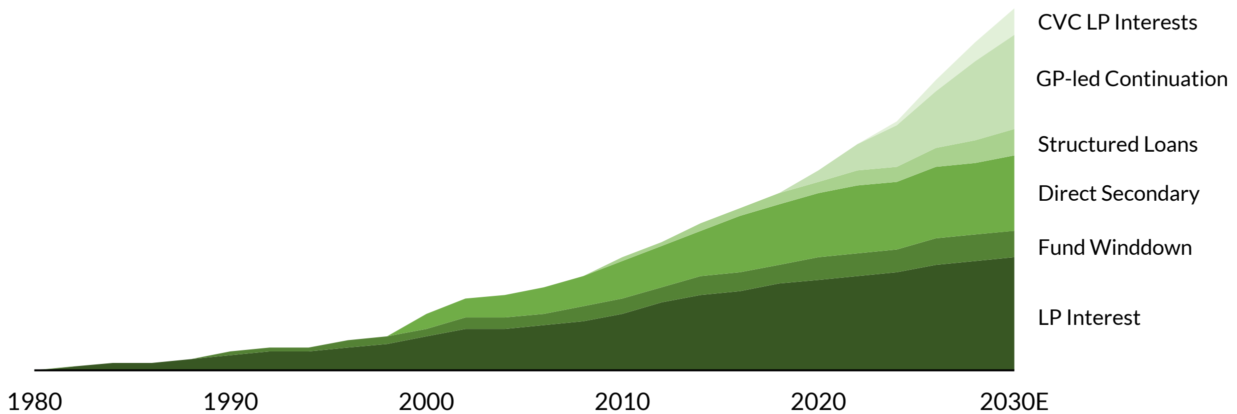
The Thirty-Year Evolution of VC Secondaries

Having operated in the venture secondary space for over twenty years, Industry Ventures has had a firsthand view of the evolution of the market, emerging from the shattered pieces of the aftermath of the dotcom bust to what we believe will be hundreds of $100M+ GP-led fund continuation vehicles. In

this post, we are sharing how the venture secondary market has matured, and our top six predictions for how it will evolve over the following decade.

The Thirty-Year Evolution of VC Secondaries[5]

Representation of VC secondary transaction volumes over time as of Aug 2022



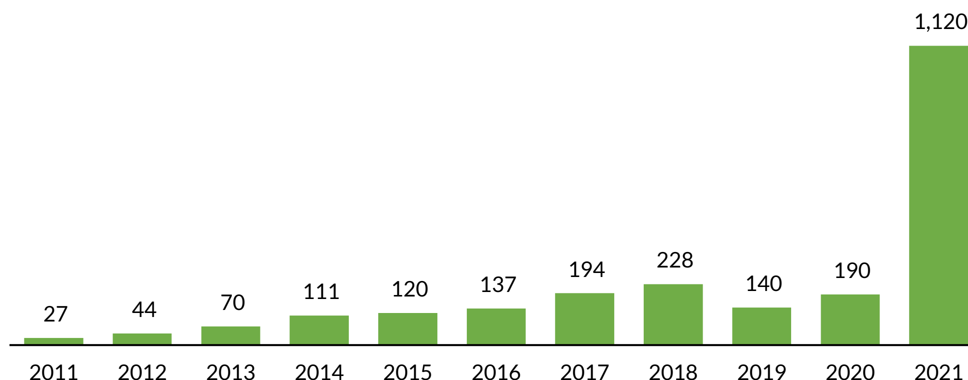
Limited Partner Interest Secondaries (also known as LP secondaries) were the first kind of secondary transactions, pioneered in the early 1980s. It is widely accepted that the first LP secondary transacted in 1979 when Dayton Carr acquired the LP interests of various venture funds from IBM. Carr went on to start Venture Capital Fund of America and launched the first-ever LP secondary dedicated fund in 1982 with $6 million. Fast forward to today, and we estimate the market for VC LP secondaries will surpass $50 billion in 2023.

Tail-end fund wind-downs started to emerge in the 1990s, and it wasn't until the early 2000s that direct secondaries gained popularity in various forms. At the time, the direct secondary market consisted of a handful of buyers focused primarily on buying the venture portfolios from corporate venture groups and hedge funds that were in liquidation. Notable examples include the sales of assets in Enron Broadband Ventures, Infospace Venture Capital, and EDS Ventures, all of which Industry Ventures purchased.

In 2009, Facebook blessed one of the first company-led secondary tender offers, a type of direct secondary transaction in which the company sponsors a repurchase of the employees' or shareholders' shares, as a way to restructure its capitalization table, and companies like Twitter and Palo Alto Networks followed suit in 2011 and 2012 respectively. Secondary tender offerings reached 228 in 2018 and exploded in 2021 with over 1,100 companies/investors offering to consolidate their shares.

# of Secondary Tender Offerings[2]

done by US-based, formely VC-backed, companies



Over the past decade, several tech-enabled exchanges have launched (e.g. Nasdaq Private Markets, Forge Global, EquityZen, SharesPost, etc.) and gained some traction, with Forge surpassing $15 billion in assets under custody in Q2 2022. Also, Nasdaq Private Markets as one of the most active tender providers in 2021. These platforms tend to serve smaller transactions and sellers of individually held common shares. Larger transactions also developed, in the form of direct portfolio strip-sales, out of early-stage venture capital funds in order to generate liquidity.

Option exercise and structured loans are popular amongst individuals with concentrated stock positions. Over the last five years, a vibrant secured-loan market developed in the private markets (similar to taking margin loans on public securities). As VC-backed companies stayed private longer, shareholders in companies like Airbnb and SpaceX took on collateralized loans as a way to access liquidity and avoid triggering the Right of First Refusal (ROFR) from an outright sale. Furthermore, these loans are typically structured to help the shareholder avoid capital gains taxes. Although we don't envision this becoming a standard option for investment funds, it will remain a viable tax-efficient option for individual shareholders. Given that these loans didn't gain widespread popularity until the bull market of 2012-2021, it is still unclear how they will perform in an extended bear market. Lenders typically do not hold the right to participate in subsequent financing rounds to protect their original loan principal, and most of these loans were collateralized against common shares, the most junior security on the capitalization table, which is paid out after preferred shareholders, and has fewer, or no, protective provisions.

Looking into the next decade, here are **six predictions** of how the VC secondary market may evolve:

#1 – We predict that Limited Partnership Interest secondaries will increase in volume, *but* transferability will increasingly be restricted. Over the next decade, we expect that the majority of these transactions will happen out of the public eye and via transfers inside an existing LP base/funds or to designated outside investors.

Similar to the direct secondary share market, we see increased adoption of ROFR provisions in LP agreements (within the VC fund entities). While this is a standard clause in real estate investment funds and sole asset LLCs, ROFRs haven't typically existed in VC funds. In fact, until recently, Industry Ventures has only seen ROFRs implemented by a dozen or so firms. However, as the market becomes more sophisticated, both LPs and GPs are requesting and adding ROFRs to their LP agreements. Therefore, we are likely entering a new era of how LP interests are transacted. Going forward, the majority of LP secondary deals will likely transact either within the existing partnership base or to new, GP-designated LPs. While we still expect LP secondary transaction volumes to grow exponentially, outsider access to the best funds will become highly restricted.

#2 – We expect the number of supersized GP-led fund continuations to dramatically increase.

Given the longer history of the PE asset class, PE GP-led continuation funds account for a significant portion of all secondary transactions today. In the first half of 2022, approximately half of buyout-fund secondaries were GP-led, 80% of which were in continuation vehicles.[6] GP-led continuation funds have historically been rare in VC, but as the asset class matures, a similar dynamic is developing.

The average tech company now takes 12 years to IPO[7], and VC GPs who hold large unrealized positions in top unicorn companies may be forced to roll their holdings into continuation funds as their traditional 10-year fund structures expire. We estimate there to be approximately $320 billion of unrealized value still held in 2010-2013 vintage funds (9-12 years old), and over $1 trillion in vintage 2016 and older[5].

NEA's $1 billion continuation secondary in 2019 was a landmark transaction for venture at the time, but with so much value concentrated in near-expiring funds, we think it will be the first of many.

A side note on the rise of GP-led transactions in VC

When executed correctly, GP-led deals can provide funds with an extended runway and/or serve as a viable third option to generating liquidity.

- *GPs unlock a new exit option, can structure the deal to retain ownership of the assets if desired, provides the opportunity for new relationships while maintaining existing relationships*
- *Existing LPs receive liquidity and/or an option to roll their interests*
- *New investors gain the ability to invest in discounted assets with the opportunity for near-term liquidity*

GP-led transaction types:

Category	Transaction type	Description
Assets Transferred	Assets Sale or Fund Wind Down	• A fund entering a wind down sells the remaining assets, which removes the burden of future audits and reporting, and distributes the proceeds
	Continuation Vehicle	• The GP transfers some, or all, assets to a new vehicle with reset economics, giving the assets more time to mature and capture further upside
Assets Retained by Fund	LP Interest Secondary	• The LP negotiates with a secondary buyer for a sale of interest and transfer of remaining unfunded commitment
	LPA Amendment	• The GP amends the LPA to extend the fund and reset economics, giving assets more time to mature and capture further upside
	Preferred LP Commitment	• The LP provides new capital in exchange for a preferred return, for offensive or defensive fund management purposes
	LP Tender or Co-Sale	• Secondary investor offers to buy the fund interests off existing LPs at an agreed price

GP-led transactions are quite popular in PE, but have historically been avoided in VC. This was a function of (i) VCs being concerned that founders may interpret it as a signal of distress or lack of commitment to the long-term, (ii) early-stage companies were typically exiting within a 10-year time frame, the term life of most VC funds, and (iii) VC was a relatively young asset class, compared to PE, and the majority of funds were yet to reach their term life. These factors are no longer true. In 2019, New Enterprise Associates announced a landmark secondary spinout and sale of almost $1 billion worth of legacy fund assets. Similar to Facebook's secondary tender in 2009, we think this transaction marked an inflection point in VC secondaries – signaling the Silicon Valley's endorsement to work with secondary funds on continuation vehicles, portfolio restructurings and strip sales. With $4.6 trillion of market value currently locked up in VC-backed unicorns, we believe more and more VCs will work with secondary funds to access liquidity and restructure their portfolios. This will further increase the size of the market and drive the next wave of growth with supersized fund continuation transactions and portfolio strip sales.

#3 – We believe Corporate Venture Capital (CVC) funds will adopt a hybrid LP model in their CVC divisions and increase the use of secondary capital to manage corporate investments.

It is well known that CVCs have, over the years, shifted their investment focus to a hybrid (strategic and financial) operating model, but we believe a similar shift will also take place at the fund structure level. Over the next decade, CVCs will increasingly raise outside capital and adopt a hybrid LP model. We are already seeing early pioneers take this approach—examples include Airbus Ventures, which has Hawaii Pacific Health Retirement Plan as an LP, and Swisscom Ventures, which was historically a single-LP evergreen fund but now pulls 75% of funds externally[1].

CVCs now account for nearly 25% of all venture capital

This shift towards a hybrid LP model, that balances strategic with financially driven motivations and uses a Limited Partnership structure to hold investments (versus directly on the parent company balance sheet), will:

- Help the CVC and parent gain flexibility around capital funding requirements;
- Allow CVCs to raise larger funds and deploy capital even if the parent reduces their allocation into the fund over time;
- Enable the CVCs to hire and retain more experienced talent through the implementation of performance fees; and
- Allow the parent to validate and benchmark the CVC unit's track record versus peers.

This model will also drive engagement with secondary funds, as a financing partner and LP. CVCs raising outside capital will likely select secondary fund partners to facilitate LP liquidity and capital management needs, as a means to maintain a level of financial independence from the parent (e.g. rather than relying on the parent balance sheet, CVCs can leverage their secondary partner for follow-on or special situation funding needs). This structure also gives the corporate parent flexibility to sell partial LP stakes, to raise cash or actively manage risk, while still maintaining broad exposure versus having to sell assets entirely. We believe that over time, most CVCs will look almost identical to traditional VCs, with multiple LPs operating under a traditional GP/LP fund structure with carried interest. From a secondary perspective this will open the door to CVC LP secondaries, a new market opportunity that does not exist today.

#4 – Tech private equity buyout activity will continue to expand and represent over 25% of the venture capital exit volume.

There were approximately 1,800 VC-backed companies valued at over $500 million in 2021.[2] Despite it being a record-breaking year for public listings and M&A, only 10% of these companies went public with another 5% being acquired. Even in the most bullish markets, the traditional paths to liquidity are not wide enough to accommodate even a fraction of the volume of VC-backed companies accumulating in the backlog. With the IPO market in flux and tech stocks down considerably from their peaks, which directly impacts a strategic buyer's ability to finance an acquisition, we believe VC-backed companies will be forced to consider the private equity buyout market as an alternative path to M&A liquidity. With over $730 billion in dry powder to deploy,[3] buyout is one of the few, if not the only, market with enough capital to absorb the growing volume of VC-backed companies. Thus, over the next decade, we believe M&A by tech buyout PE groups will account for upwards of 25% of venture capital exit volume.

#5 – Large publicly traded asset managers will buy venture capital firms, paving their way into the venture capital and technology growth markets.

In a prior blog post we discussed the exponential growth in venture deals carried out by non-traditional VCs (hedge funds, mutual funds, family offices, etc.). While a few of these groups have already established themselves as reputable direct venture investors, we've tracked an adjacent group of entrants that are subtly buying their way in via acquisitions. We see acquisition appetite coming from three fronts: name brand asset managers that are looking to enter venture capital, top-tier adjacent category investors (private equity, hedge fund, credit, etc.) who want to diversify their offerings, and possibly larger venture capital firms that want to build out a diversified venture platform. The chart below shows notable acquisitions of VC firms done by large asset managers in just the past year. While these acquisitions have been focused around sector specialists, we see this appetite broadening across larger firms (with $2B+ AUM) and more generalized venture capital platforms and lenders.

Notable Acquisitions of VC Firms Since 2021[2]

Acquirer	Target	Target AUM	Target Focus
The Carlyle Group	Abingworth	$2B	Life Sciences
Apollo Global Mgmt	Sofinnova Ventures	$2B	Life Sciences
EQT Partners	Life Sciences Partners	$2B	Life Sciences
StepStone Group	Greenspring Associates	$9B	Venture Capital
Franklin Templeton	Lexington Partners	$55B	Private Secondaries

#6 – We believe a handful of large multi-strategy venture capital firms will go public, similar to what happened with PE buyout firms over the last decade.

Over the past few years, a number of VC firms have begun diversifying their strategies. Sequoia Capital created the Sequoia Fund, an evergreen fund to hold public securities, General Catalyst registered as a RIA (Registered Investment Advisor) allowing it to hold non-qualifying assets, and Andreessen Horowitz notably hired the CIO of Jordan Park to build out its in-house wealth management division. This diversification will allow these firms to expand their asset base beyond just venture capital and help to position them as more generalized asset managers, and more favorably in the public markets.

While public venture capital partnerships have existed (e.g. Internet Capital Group and Safeguard Scientific), most have either failed due to timing, or remain subscale. Historically, PE firms needed more than $30 billion of AUM to consider an IPO. As the venture capital asset class has grown, and many firms diversified across multiple fund offerings, a few have reached sufficient scale to IPO. In fact, it is rumored that growth-equity firm General Atlantic is currently exploring an IPO (link to Bloomberg article). We expect to see a handful of prominent venture capital firms go public over the next decade.

Large US VCs by AUM as of Aug 2022[2]

VC	AUM	Founded
Sequoia Capital	$85.5B	1972
General Atlantic	$84.4B	1980
Andreessen Horowitz	$35.0B	2009
General Catalyst	$33.3B	2000
TCV	$24.0B	1995
Kleiner Perkins	$20.0B	1972
New Enterprise Associates	$20.0B	1977
Bessemer Venture Partners	$19.0B	1911
Lightspeed Ventures Partners	$18.0B	2000

At Industry Ventures, we've recognized through our 22-year history of specializing in VC secondaries that change in the venture landscape moves as fast as change in the technology sector itself. As such, we're constantly recalibrating our firm to position ourselves for the changes we see ahead. For instance, we've formed three adjacent fund strategies over the past twelve years, all while maintaining our flexible approach to deal structuring. Today, our presence across the entire venture landscape, from early-stage, to secondaries, to tech buyout, provides us with unique insights into how the market is evolving.

As we look forward into the next decade, we believe the VC secondary market is at an inflection point both in terms of transaction volume and market participant sophistication. In the near-term, with the IPO markets closed for the time being and macroeconomic uncertainty impacting prices across asset classes, institutional portfolios are wrestling with the strongest denominator effect since 1969[4]. As a result, we expect shareholders behind the growing backlog of 1,300+ venture-backed unicorns to overwhelm the alternative liquidity options, and in particular the secondary markets. Deals sizes will swell, access will become increasing limited, complexity will continue to grow, and unconventional deal structures will arise. As the VC secondary market evolves and further matures through the next decade, investors will need to look forward, rather than in the rear-view mirror and relying on yesterday's playbook.

Sources:

[1] Global Corporate Venturing; Five tips for VCVs who want external LP money (https://globalventuring.com/corporate/five-tips-multiple-lp-fund/); June 28, 2022.

[2] Pitchbook.

[3] Joost Spits, Thomas Wendt, Dustin Rohrer; Bain & Company; Harnessing the True Value of Corporate Venture Capital (https://www.bain.com/insights/corporate-venture-capital-m-and-a-report-2022/); February 8, 2022.

[4] Jay Kloepfer; Callan; Unprecedented Territory—and the Inherent Limits of Diversification (https://www.callan.com/blog-archive/stock-and-bond-declines/#:~:text=Looking%20at%20annual%20returns%2C%20there,near%2Dmiss%20in%202018); May 23, 2022.

[5] Industry Ventures Market Intelligence.

[6] Lazard Private Capital Advisory; Sponsor-Led Secondary Market Report H1'11 (https://www.lazard.com/media/452213/lazard-sponsor-led-secondary-market-report-h1-2022.pdf); August 2022.

[7] Jay R. Ritter; University of Florida; Initial Public Offerings: Technology Stock IPOs (https://site.warrington.ufl.edu/ritter/files/IPOs-Tech.pdf); May 18, 2022.

[8] Crunchbase; The Crunchbase Unicorn Board (https://news.crunchbase.com/unicorn-company-list/); June 20, 2022.

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