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GARAGE: OUTLOOK 2022

Early investor exits open up hot secondary market for startup equity

More products appearing as market matures; and with tech companies staying private longer, expect more 'continuation funds' to emerge

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THE meteoric rise of South-east Asia's startups has injected life into the market for secondary transactions in startup equity, as early-stage investors look to exit their portfolio companies while private equity players find ways to get in.

South-east Asia's startup ecosystem was seeded some 10 years ago with the birth of venture capital (VC) firms focused solely on the region. But VC fund lives are coming to an end, and these early investors are selling their stakes in companies to late-stage investors wanting to get in on the action.

Record levels of dry powder amid a low interest rate environment have spurred growth-stage investors to take larger stakes in tech companies. When funding rounds are oversubscribed, investors can get a bigger slice of the company by buying shares off existing backers looking for liquidity.

Grab's early investor Vertex Ventures, for instance, made a 9 times return through secondary sales, according to an investor presentation seen by *The Business Times* in July.

While the secondary market continues to be opaque – often closed-door deals without a standard mechanism for price discovery – industry players have pointed to mounting activity in the space over the past year.

"Key secondary investors (in Asia) have been super busy and have announced at least US$1 billion of executed deals. Given that this market has been active only over the last 5 to 6 years, this is quite an achievement," said Soma Ghosal Dhar, CEO of secondaries advisory firm Candor Asia Advisors.

Vinnie Lauria, managing partner of VC firm Golden Gate Ventures, saw a high demand this year for secondaries of GoTo, Xendit and Stripe. He believes the secondaries market will grow as retail investors try to gain early access to companies headed for an initial public offering. In some of these cases, secondary investors are offering to buy shares in the startup at a premium to the latest valuation.

Secondaries are often bought at a discount to the startup's latest valuation due to less preferential terms tied to earlier classes of shares. Discounts ranged from 20 to 30 per cent some 12 to 18 months ago, going by transactions on private investment platform Fundnel. These days, they've narrowed to 10 to 15 per cent or less.

All this action in the market has led to fund managers setting up vehicles or raising more money solely for secondary investments. Singapore-based Indies Capital in July hit the first close for its second fund focused on secondaries, with commitments of over US$56 million. The firm has since raised over US$100 million, past its US$80 million target.

"We felt that there was nobody filling the gap in terms of intermediate liquidity," said Indies partner Harold Ong. "And ultimately what that did for our investor base was to create a new product. You end up having more of a diversified pool of mature new economy assets, because when you buy these companies in their seventh or eighth year, you no longer have to wait that long to exit."

A network of individual brokers who connect buyers and sellers has also sprung up. Most focus on family offices that invest with smaller cheques, and are interested in sought-after companies with minimal due diligence conducted. The brokers are understood to charge anywhere from 1 to 5 per cent for a commission.

As tech companies stay private longer, industry players are expecting the emergence of more "continuation funds" so fund managers can hold on to well-performing companies even as the fund reaches its end.

It reflects a growing desire in the VC space to break the shackles of a traditional 10-year cycle. Sequoia's limited partners (LPs) are investing in a newly launched open-ended Sequoia Fund, which allocates capital to a series of closed-end subfunds that invest at every stage – from inception to IPO. It essentially removes all artificial time limits, Sequoia said.

Meanwhile, early-stage South-east Asian VC firms such as East Ventures and Openspace have launched growth funds to invest in Series B and C rounds, in part to double down on maturing companies the firm seeded.

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In "continuation fund" structures, a separate vehicle is set up to buy the assets from the existing fund. LPs of the fund are given the option to either cash out, or remain invested in the portfolio via the new vehicle.

"It gives (fund managers) a sort of reset button for the next few years," said Ghosal Dhar, adding that it takes at least 10 to 15 years for a company to be successful.

"If you were an investor in Grab between 2012 and 2014... but were forced to divest (just as the transport app was gaining momentum), you would've lost this huge multiple expansion in valuation. A lot of general partners who understand the portfolios and their trajectory and momentum – they're very reluctant to sell these portfolios early," she said.

Vertex Ventures last year set up a continuation fund for its South-east Asian and Chinese assets, DealStreetAsia reported. The fund is backed by Liechtenstein-based private banking and asset management group LGT.

Besides early investors, startup employees have become a growing source of secondary deals. With employee stock option plans (ESOPs) getting more common, a handful of startups are finding ways to help staff partially cash out ahead of an IPO or trade sale.

Sell interest to-date on Fundnel has exceeded total sell interest for the whole of 2020 by 11 times. This was driven by ex-employees monetising their vested shares after exercising their ESOPs, and institutional investors seeking to recycle capital, said Fundnel CEO Kelvin Lee.

Meanwhile, private investment platform Funderbeam Exchange plans to tap deeper into the growing secondaries space. Data from Jefferies showed that 2021 is expected to end with over US$100 billion in global alternative investments in secondary markets.

Soma Ghosal Dhar, CEO of Candor Asia Advisors, says continuation fund structures give fund managers a sort of reset button for the next few years.
PHOTO: SOMA GHOSAL DHAR

"This figure is forecasted to reach US$250 billion in the next five years. Innovation, technology and adoption are driving present volumes," said Jacqueline Yee, CEO of Funderbeam Exchange.

Funderbeam's Singapore team has set its sights on ambitious startups and unicorns in South-east Asia and the Asia-Pacific. The company is also launching a broker link product for day traders and family offices to offer alternative access points to its marketplace.

As the uncertainty around macroeconomic and geopolitical conditions extends into 2022 Yee is keeping an eye on inflation rates and growth indicators – specifically supply chain dislocations and employment levels – that could impact financial markets.

"In an on-again, off-again market going into 2022, perhaps an important takeaway...is for a more nuanced active investment portfolio management strategy," said Yee. "(This includes) layering in risk-off with more accessible alternatives such as tradable startup shares, and secondaries buyouts, deeper liquidity pools and diversification."

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