StepStone
inside private markets

How a Bear Macroeconomy Can Mean a Bull VC Secondary Market

The current global economy is unlike any we've seen in recent memory. Inflation hasn't topped 7% in the US since the early 1980s, and the Fed has not utilized rate hikes in a sustained way to cool the economy since that period. In public markets, rising rates and the possibility of a recession have caused investors to reassess the value of risk assets. These dynamics have led to a steep decline in all public market indices this year. Naturally, with rising rates, longer-duration bond portfolios are similarly underwater.

It is undeniable that these economic pressures have presented institutions with short-term challenges. However, for investors with a long-term view and the ability to dynamically allocate capital, we believe there is a silver lining. The secondary market is one of the few spaces in the alternative investment universe that may be considered somewhat countercyclical. Generally, when the economy contracts, the opportunity set expands, and the pendulum swings in favor of the secondary buyer. While this is a widely accepted characteristic of the market, the factors that contribute to this dynamic are less understood. Here, we will unpack why we believe the volume, quality and attractiveness of the opportunities afforded to our platform in the coming years may surpass any previous era.

November 2022

Factor 1: Elongated Time to Liquidity

THE BACKGROUND

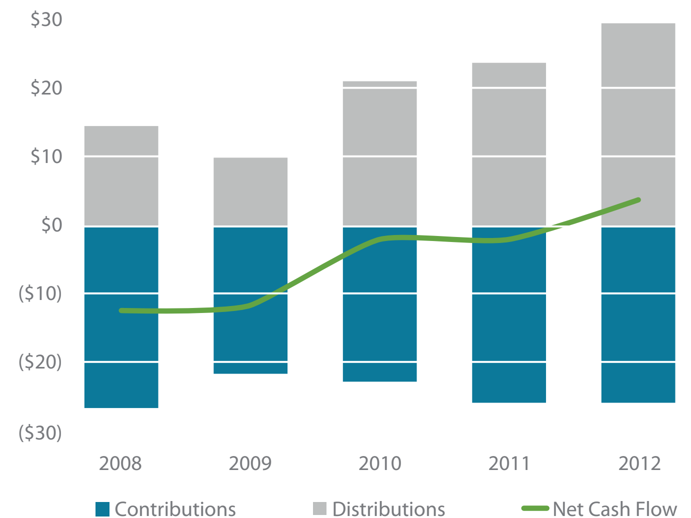
The time from initial funding to ultimate exit in venture has averaged approximately six years for M&As and seven years for IPOs, respectively, over the past three years. This time horizon has expanded materially since the early 2000s. Greater access to later-stage capital—coupled with more market participants, a higher level of scrutiny on size and scale at IPO by public market investors, and more opportunities for partial liquidity—has been a contributing factor. This trend is truly systemic. We believe it marks a seismic change in the importance of private market investments in the life cycle of start-up companies. In the short to medium term, we expect macroeconomic factors to further lengthen the time to liquidity in the venture ecosystem. A total of 59 venture-backed companies completed IPOs during the first three quarters of 2022, 167 fewer than in 2021. The aggregate post-offer value of these businesses totaled $30 billion, over $473 billion less than the prior year.[1] The same dynamics hold true in the M&A market with 650 private venture-backed companies sold for a collective value of $31 billion, down 56% relative to the first three quarters of 2021.[2]

The aftermath of the Global Financial Crisis (GFC)—which we define as 2009, 2010, 2011 and 2012—represents the best proxy for another recent period characterized by a closed IPO window and tepid M&A market.

- In 2006 and 2007, before the effects of the GFC were materially felt in the venture market, a total of 69 and 95 venture-backed companies completed IPOs for aggregate post-offer values of $11 billion and $24 billion, respectively.
- During 2010–2011, 61 fewer companies went public compared with the years leading up to the GFC (2006–2007). The average time from initial funding to exit extended by five years for both M&As and IPOs.[3]

While it is impossible to predict the magnitude and the longevity of the current market cycle, we expect a similar increase in hold periods and decrease in exit activity for the short to medium term.

FIGURE 1 | HISTORICAL US VC CASH FLOWS DURING THE GFC (BILLIONS)



Source: PitchBook-NVCA Venture Monitor, September 30, 2022.

THE PROBLEM

Figure 1 shows the cumulative capital calls and distributions made by US VC funds between 2008 and 2012. Net negative cash flows characterized this period as capital calls materially outpaced distributions. On the other hand, distributions in 2021 soared past prior highs to $98.4 billion, creating positive net cash flows for the industry. The quantity of distributions allowed many investors to use realizations to fund capital calls. Using the conditions during the GFC as a proxy, we believe the pace of distributions will slow in the coming quarters and years, thereby turning net cash flows negative and eliminating the ability to pay capital calls from distributed proceeds. This dynamic is problematic for LPs and GPs alike.

To fund capital calls, make new commitments, support operating budgets and cover other expenses, LPs must accrue a baseline amount of distributions. It is unclear whether this baseline will be achieved in the coming years. This leaves investors with several options.

[1] Q3 2022 PitchBook-NVCA Venture Monitor.
[2] Ibid.
[3] Ibid.

They could slow down their pace of deployment to illiquid assets, but why sit on the sidelines? As we've said before, great companies are created in every market environment. Alternatively, investors could sell their positions on the secondary market.

Venture GPs, especially emerging firms with less proven track records, face a similar quandary. Over the past 10 years, more than 2,000 first-time venture funds raised approximately $89 billion.[4] While some of these firms have developed into well-known brands with no issues securing investor commitments, the majority must continue to prove out their track records through realized returns to successfully raise capital. To get a better sense of the magnitude of the unrealized value and modest amounts of capital returned by smaller, early-stage funds, we examined their portfolios based on median residual value to paid-in capital (RVPI) and distributions to paid-in capital (DPI). We limited our analysis to funds capitalized at or below $250 million (i.e., micro VC funds) that completed fundraises between five and 10 years ago. The result of this exercise is included in **Figure 2.**

On average, funds that are between five and seven years old have returned less than half of investor paid-in capital, while most of the total value is tied up in illiquid, unrealized investments.

With portfolios awash in unrealized value, fewer immediate exit opportunities and longer hold periods on the horizon, GPs will need to get creative to generate liquidity. Many may seek to restructure more mature funds through full LP tenders, strip sales or other secondary solutions.

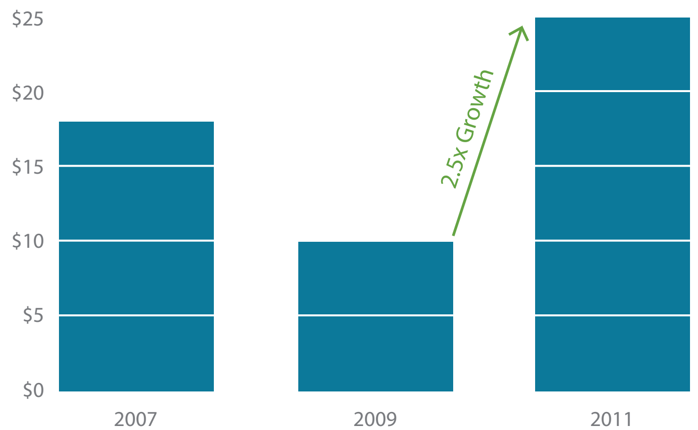
Even though the secondary market, especially the VC portion, was nascent at the time, the period immediately following the GFC saw secondary volume skyrocket (**Figure 3**). With similar macro forces at work plus more sophisticated structures and investors, we expect a similar, if not greater, uptick in this opportunity set.

FIGURE 2 | REALIZED VS. UNREALIZED RETURNS FOR RECENT MICRO VC FUNDS

Micro VC Performance Metrics			
Vintage Year	**# Of Funds Included**	**Mean RVPI**	**Mean DPI**
2012	34	2.40x	0.98x
2013	36	3.46x	0.80x
2014	36	2.14x	1.02x
2015	45	2.13x	0.40x
2016	42	2.11x	0.48x
2017	54	1.98x	0.13x

Source: Preqin, June 30, 2022.

FIGURE 3 | GLOBAL FINANCIAL CRISIS SECONDARY MARKET VOLUME (IN BILLIONS)



Source: 2014 Greenhill Global Secondary Market Review

[4] Ibid.

FIGURE 4 | ILLUSTRATIVE EXAMPLE OF THE DENOMINATOR EFFECT

Size of Plan ($ in Millions): $10,000					
Asset Class	**Original Allocation (%)**	**Original Allocation ($)**	**% Decline**	**New Allocation (%)**	**New Allocation ($)**
Equity	50%	5,000	30%	47%	3,500
Fixed Income	30%	3,000	30%	28%	2,100
Alternatives	20%	2,000	5%	25%	1,900

Factor 2: The Denominator Effect

The denominator effect is a widely cited factor contributing to secondary market selling. It is the phenomenon by which performance in other, more liquid asset classes (i.e., public equity markets and fixed income) declines more rapidly and materially than in the private equity markets.

THE BACKGROUND

Through the first half of 2022, the S&P 500 was down 21%, while the NASDAQ Composite was down 24%. While more difficult to track, longer-duration bond portfolios were down by similar levels. Using SPI, the US VC Index was down 15%.[5] The sharp decline in valuations has a profound effect on an institution's asset allocation mix. It serves to decrease the denominator of the plan's assets, such that a less material decline in the performance of illiquid assets inflates their percentage of the overall investment pool. **Figure 4** shows a hypothetical example.

THE PROBLEM

In two quarters alone, a plan's denominator could have contracted by 25%, inflating allocations to alternatives by 5% or more. While 5% may not seem like a massive swing, it could place an institution outside its stated policy limit. In these circumstances, institutions may be compelled by boards or trustees to act. Data from several market cycles suggest secondaries are commonly used as a tool to reduce exposure to alternatives, helping to combat the denominator effect.

Factor 3: Strong Recent Performance/ Opportunistic Selling

The behavior in the sections above can be described as "needs-based selling." Institutions need liquidity for fear that the pace of distributions will slow such that future liquidity will not sufficiently cover their liabilities. Although needs-based selling is an important driver of the secondary market, some institutions will also contemplate opportunistic sales.

THE BACKGROUND

In general, over the past five years, most venture funds have experienced strong performance accretion. The Burgiss US VC Index, which tracks the performance of over 3,000 funds, for example, outpaced the S&P over three and five-year periods by 1,863 and 1,353 basis points, respectively.[6] For reference, the same index outperformed the traditional private equity index by 1,189 and 874 basis points over the same periods. Similarly, the since-inception returns for funds that have matured over the past five years tend to be stronger than

[5] StepStone Private Markets Intelligence, or SPI, is our proprietary private markets research library, June 30, 2022.
[6] Burgiss Private iQ Direct Alpha Calculator.

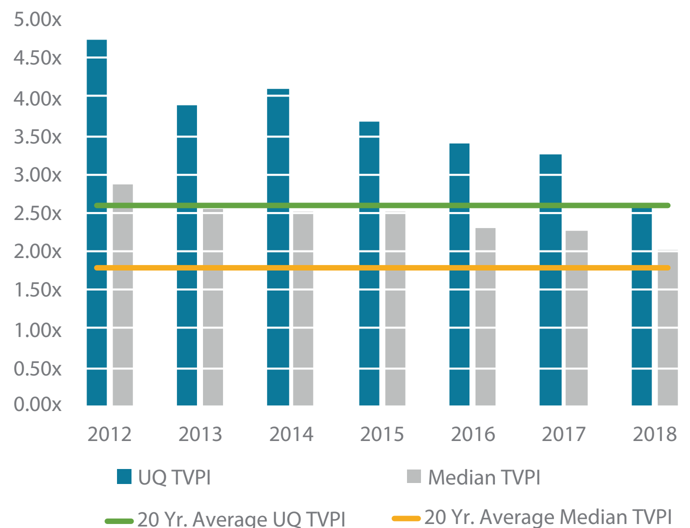
other vintages. Vintages that fit these criteria include those from 2012 to 2018. **Figure 5** illustrates the upper-quartile and median performances for each vintage and compares them with the long-term averages. Upper-quartile net multiples for six of the seven vintage years exceed 3x, and the median net multiple for all seven vintage years exceeds 2x.

We believe several factors contributed to VC's recent outperformance.

1. An open and receptive exit market;
2. An influx of active and deep-pocketed late-stage investors; and
3. Excellent technological tailwinds including those accelerated by the pandemic.

This outperformance has resulted in a tremendous amount of embedded value in mature funds. The collective NAV of 2018 or earlier vintage venture funds is approximately $1.4 trillion or, for a scale comparison, roughly the GDP of Spain.[7]

FIGURE 5 | UPPER-QUARTILE AND MEDIAN PERFORMANCE OF MATURE VC FUNDS VS. LONG-TERM AVERAGES

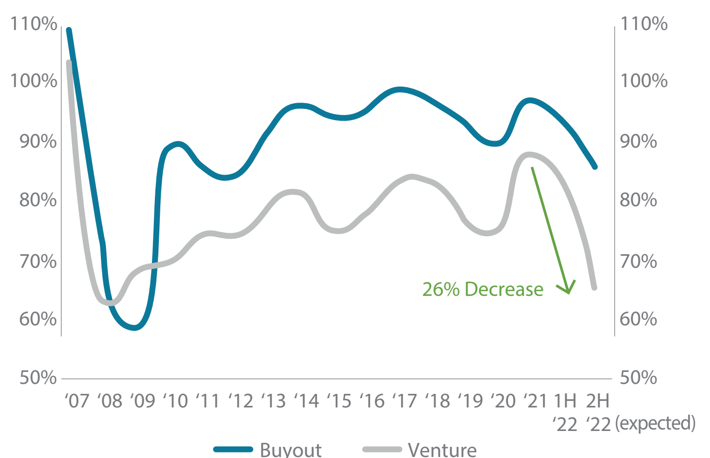


Source: Burgiss Private iQ, June 30, 2022.

THE PROBLEM

The problem is somewhat counterintuitive. In fact, it may even be a good problem. Venture has performed well recently on both a relative and an absolute basis so certain institutions will consider selling to crystallize gains in anticipation of economic headwinds. Some sellers may also be motivated by the ability to then redeploy the proceeds to newly formed venture funds in what will most likely be a more favorable valuation environment. While less urgent than needs-based selling, opportunistic selling can further enhance the opportunity set for secondary buyers in the coming quarters and years.

FIGURE 6 | SECONDARY PRICING OVER TIME (% OF NAV)



Source: Jefferies International limited, November 2022.

Impact on Pricing and Performance—the New Normal for VC Secondaries

As the supply of secondary portfolios increases, barring any influx of new demand, the ecosystem can quickly turn into a "buyer's market." Buyers can thus negotiate steeper discounts, which should contribute to better end-of-day performance.

Figure 6 highlights the dramatic increase in discount levels during the period immediately following the GFC and a similar spike in the second half of 2022.

[7] Preqin, March 31, 2022.

If you accept that the current state of the economy can lead to greater selling volume, then the next logical question is, will the demand for venture secondaries stay relatively consistent? We believe the answer is yes for a myriad of reasons. There are tremendous barriers to entry as a result of the inherent inefficiencies in the VC Secondary market. Most VC fund managers have clauses in their limited partnership agreements that allow them to veto secondary sales. Many will solely accept secondary buyers who are existing primary investors in their funds. Others will simply connect LPs interested in selling to a small number of pre-approved buyers—most of whom are long-standing partners.

Large traditional private equity secondary players also generally avoid venture for a few reasons. VC funds tend to be more challenging to evaluate than private equity funds, as portfolios are typically made up of private companies that have not yet reached profitability and little information is publicly available on the operational performance of these companies. Finally, given their size relative to traditional buyout funds, positions in venture secondary offerings tend to be too small for larger players. Our global scale, tenured team, proprietary data and over 240 active GP relationships help us to take advantage of these market inefficiencies, which are amplified in the current market environment.

Conclusion

Increased time to liquidity for venture-backed companies, faltering public equity performance straining available capital, and strong recent VC outperformance present a unique environment in which to deploy capital in secondary transactions. Amid this market dislocation, few institutions will be able to pursue VC secondaries effectively. As the single largest allocator to VC funds on a primary basis, we believe StepStone has a differentiated relationship and data advantage that can put our team of VC investors in a privileged position to help execute on the coming opportunity set. We look forward to the quarters and the years to come, as they may be, in our belief, some of the most rewarding in the venture secondary market.

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