ACCESSING LIQUIDITY IN AN ILLIQUID MARKET

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Introduction

Historically, shareholders in private companies have been expected to hold their shares through an IPO or M&A event. These traditional mechanisms for generating cash liquidity were prevalent in the years preceding 2022, with a record-setting number of companies either going public or getting acquired. However, in 2022, exit volumes have declined meaningfully. With very few IPOs and acquisitions currently taking place, shareholders now face an illiquid market, with greater difficulties in realizing liquidity for their private shares.

Against this backdrop, the secondary market has continued to emerge as an alternative source of liquidity. Realizing liquidity for private shares through a secondary transaction can achieve many goals for both companies and their shareholders. Secondary transactions can realign the investor syndicate, secure additional follow-on capital for future rounds of financing, and retain and motivate existing employees.

Secondary transactions can take many forms, such as company-led liquidity programs for employees or one-off transactions that can address a specific liquidity need for an investor group. In the current market environment, companies and shareholders may benefit from considering some of these liquidity options, to address both one-time as well as ongoing strategic needs.

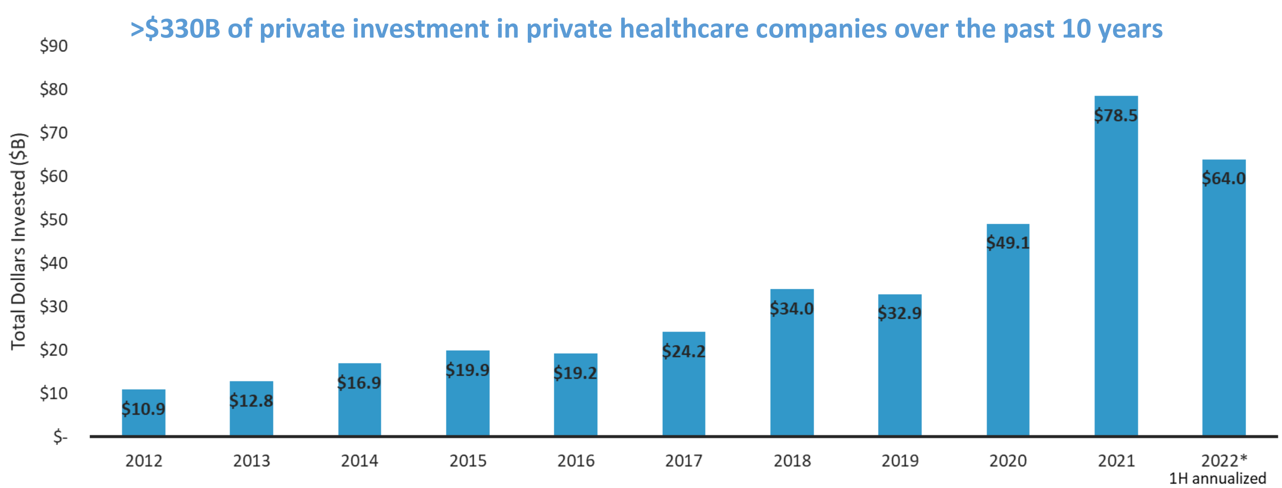
Revelation Partners

In This White Paper:

Overview of Today's Healthcare Market

Over the last ten years, venture capitalists, corporations, angel investors, and other parties have invested over $330 billion in private healthcare companies. In 2021 alone, private healthcare companies raised over $78 billion, more than double the amount raised in 2019. While the pace of investment has declined slightly in 2022, both 2021 and 2022 are poised to be record-setting years for private healthcare investment.

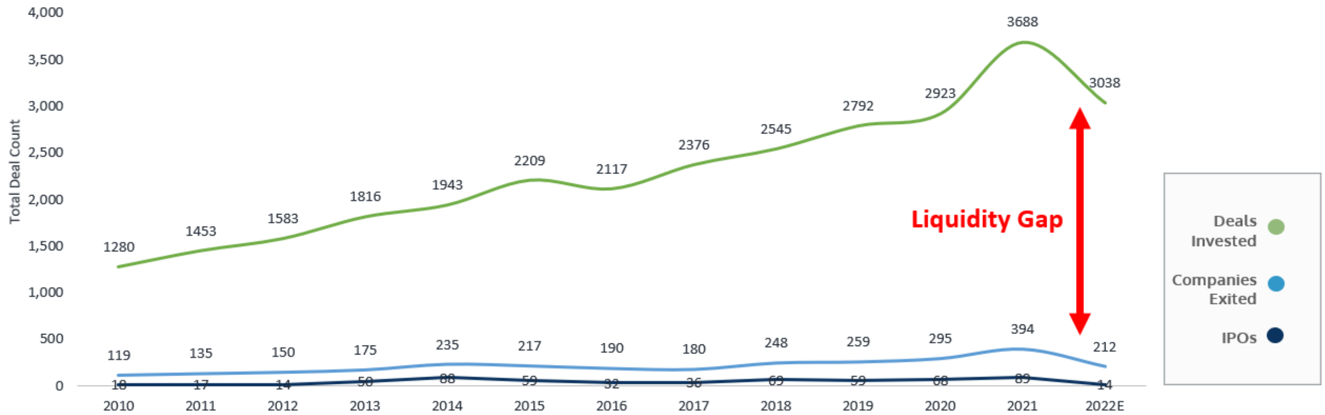
Private Investment in Healthcare[1]



[1]Q2_2022_Pitchbook_NVCA_Venture_Monitor. SVB – Healthcare Investments and Exits – Mid-Year 2022

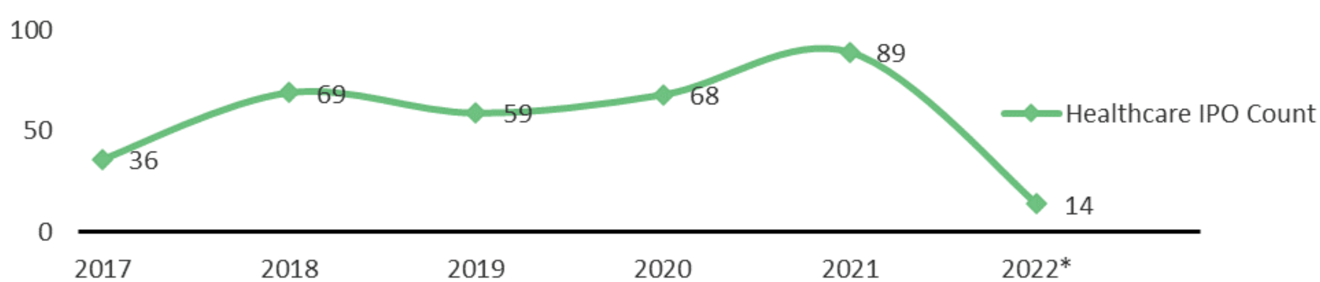
Meanwhile, there exists a persistent "liquidity gap." The $330 billion of private healthcare investment over the past ten years has gone into more than 25,000 deals. However, less than 11% of these deals have achieved an exit. As a result, there is a large gap between the number of new deals and company exits during this time, resulting in a build-up of unrealized private value[2].

Number of New Deals Versus Number of Exits[3]



In addition, companies are staying private longer, whether by choice or due to market conditions. On average, it takes five years for private healthcare companies to be acquired or six years for private healthcare companies to go public.[4] This trend is further exacerbated by the current market conditions. As illustrated by the chart below, healthcare IPOs have declined dramatically in 2022, to their lowest point in more than five years.

Number of Healthcare IPOs[5]



As a result of these market conditions, many different shareholder groups may desire liquidity for their private positions. A healthcare company will likely have one or more of these groups on its cap table and may proactively consider secondary option(s) to address ongoing needs within the investor syndicate. As outlined below, a secondary solution may benefit the company and shareholder(s) alike.

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[2] Q2_2022_Pitchbook_NVCA_Venture_Monitor; SVB – Healthcare Investments and Exits – Mid-Year 2022

[3] SVB – Healthcare Investments and Exits – Mid-Year 2022; Q2_2022_Pitchbook_NVCA_Venture_Monitor; JP Morgan Healthcare Market Update October 2020

[4] SVB – Healthcare Investments and Exits – Mid-Year 2020; Bain 2022 Analysis

[5] RBC Healthcare IPOs; SVB – Healthcare Investments and Exits – Mid-Year 2022; Q2_2022_Pitchbook_NVCA_Venture_Monitor; RP Estimates (2022)

- *Venture Capital Firms* may need to increase their reserves for portfolio companies. While late-stage private companies will continue to need capital to fuel growth, the current market environment may make it challenging for firms to make new investments. In these cases, a company would rely on its existing investor syndicate for additional capital, which could result in venture firms needing to reserve more capital than originally anticipated for their existing investments. As exits become delayed, venture firms may also face a requirement to dissolve their investment vehicle prior to realizing investments, a desire by the general partners to recapitalize their funds, or a desire by their limited partners to rebalance and/or end manager relationships. As a result, a number of venture funds either desire, or are required by the terms of their governing documents, to seek liquidity for their existing investments.

- *Corporates* may underfund or abandon investment portfolios. Corporations have historically invested billions of dollars in private healthcare companies. They typically make decisions about their private investments based on the corporations' strategic priorities rather than solely on financial returns. When mergers, acquisitions, or strategic shifts occur, many of these investments become non-core to these corporate investors, and thus, are frequently abandoned by such groups.

- *Individuals* are typically founders, members of the management team, employees, or angel investors that supported a company in its infancy. These individuals may continue to have a role with the company either as a manager or board member, or they may no longer have an active involvement with the company. What is common amongst them is that they may each have unique personal motivations that cause them to seek liquidity for private shares.

- *Crossover Funds* may seek liquidity for their private holdings. As the IPO window remains closed for the time being, crossover funds in particular, may seek to reduce their late-stage exposure for similar reasons as other venture capital firms.

Why Secondaries?

As a company grows and matures, it may face several 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., corporates, venture capital firms, crossover 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.

Ensuring the Availability of Follow-On Financing. As healthcare companies raise multiple rounds of private financing, its capitalization table may become crowded with older, 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 "older" investors, but also "refresh" the investor syndicate, serving as a source of fresh capital to support the company's ongoing growth objectives, often at the same time as completing a secondary transaction.

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.

Types of Secondary Transactions

Secondary transactions can be highly customized to solve the acute needs of a company and/or shareholder. Two broad structures include company tenders and one-off shareholder transactions.

Company Tender / Preferred Buyer Program. 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, a secondary 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. By identifying a single secondary partner, it reduces the burden on the company to share information with multiple 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.

One-off shareholder liquidity. A secondary partner can also provide liquidity to shareholders and limited partners on an ad-hoc basis. Individual shareholders of companies such as founders, early investors, or management team members may seek to diversify their holdings while the company waits for a formal exit. A secondary partner can work directly with the shareholder to provide a customized solution that addresses an acute need for liquidity.

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.

Finding the Right Secondary Partner

A company may find secondary buyers for their shares through outreach to counterparties such as:

- Existing investors, who may want to increase their exposure to the company
- Traditional primary investors, who may want to invest in the company
- Fund-less sponsors, who may need to raise capital in order to transact
- Brokers, or secondary exchanges which can list the shares for purchase by any groups, or
- Secondary investment firms

Healthcare companies should seek a dedicated partner with the sector expertise, transaction experience, and financial wherewithal to optimally complete a secondary transaction. From the company's perspective, the secondary buyer should serve as a long-term partner, supporting the company operationally and financially, as well as provide ongoing liquidity for shareholders (including future secondary purchases). As the median time to exit for private healthcare companies remains high, a secondary partner can play a vital role for both the company and its shareholders.

Sector expertise. A secondary partner with specific sector expertise can contribute to a smoother due diligence process and optimized pricing for the shares, based on an understanding of the specific regulatory, commercial, and legal dynamics issues faced by a company. A knowledgeable investor is especially valuable when information access is limited.

Transaction experience. A company may want to ensure that they are working with a registered investment advisor. An unregistered investor will have limitations on how much capital they can deploy in secondary transactions which will affect their ability to close. Further, option exercises, company tenders, and one-off secondary transactions are typically more complex than primary investments, given the unique structuring, legal, and tax considerations of the process. An experienced secondary partner can help the option holder navigate these considerations, ensuring a smooth process and expeditious closing.

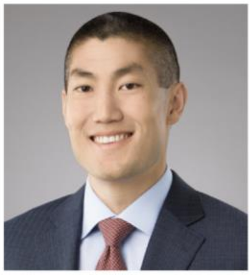
Dedicated Capital. A well-capitalized partner, with a dedicated capital pool, can ensure an expeditious closing. Moreover, a well-capitalized investor can provide future support for the company, including capital reserves to participate in follow-on financings, as well as the ability to execute additional future secondary transactions.

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 14-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.

About the Authors



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