diffusetap
Virtual Event Series

Access Liquidity via Secondaries

Guest Speakers:

Brad Heppner
Founder and CEO
The Beneficient Co Group

Dave McClure
Founder/Managing Partner
Practical Venture Capital

Hosts:

Kenny Estes
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DiffuseTap: Access Liquidity via Secondaries

Last time on DiffuseTap, **Brad Heppner, Founder, CEO, and Chairman of The Beneficient Company Group**, and **Dave McClure, Founder & Managing Partner of Practical Venture Capital** talked about the ins and outs of the secondary market, how funds typically value secondary assets, and how to get to liquidity through secondaries.

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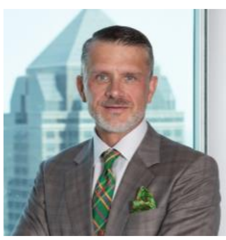
DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas) … straight from your armchair like a boss.

Meet the Speakers



BRAD HEPPNER is the Founder, Chairman, and CEO of The Beneficient Company Group, a platform for individual and small institutional investors to access liquidity from their alternative assets in a simple, rapid, and cost-effective way.

LinkedIn: @brad-heppner

DAVE MCCLURE is an engineer, entrepreneur, and an investor in Silicon Valley for over 30 years. Having founded 500 Startups and Practical Venture Capital, Dave has invested in hundreds of startups around the world, including 20 unicorns and 5 IPOs.

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About Diffuse

We are an alternative fund platform offering differentiated investment products. From digital assets to VC funds and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds. For more information, visit www.diffusefunds.com.

KENNY ESTES: Today, we have Brad Heppner and Dave McClure. Brad, do you want to briefly introduce yourself and what you are up to over at Beneficient?

BRAD HEPPNER: Thank you for having us today. I appreciate the opportunity to share about Beneficient, and a little bit about myself as well. I started in alternative assets back when the asset class had only two types of investments: either in a venture capital fund, or an LBO fund. This is going back 35 years ago. In 1995, I purchased the oldest fund of funds that invested in venture capital and in buyout funds. It was founded in 1978 and raised the first fund of funds in 1980.

It was a very large run of over 100 million dollars. That platform and our fund of funds platform invested in many of the original types of venture capital firms, from Kleiner Perkins to NEA Matrix, Menlo, and so forth.

We also invested in large cap buyout firms, structured credit firms, and so forth. We built that platform. We also started a fund administration company that administered the funds on behalf of limited partners, called Capital Analytics.

We also started an insurance company in Bermuda. It was a property and casualty insurance company that insured limited partners against the risk that their managers had experienced, which are losses due to negligence or misconduct, fraud, Ponzi schemes, and so forth. We then began selling those companies.

I sold our platform to Lehman Brothers in 2003, and I sold Lehman Brothers, the company act platform, in 2008, shortly before the bankruptcy. Out of Tokyo, Mitsubishi bank bought the fund administration company and operates here in the United States, under MUFG Capital Analytics. Then, we began Beneficient.

What Beneficient does is it provides the limited partner with liquidity out of alternative assets. However, we're not like a secondary fund, because we've organized under the new laws of the state of Kansas, which focus on alternative asset managers such as many of you here and liquidity providers, to alternative asset managers. Kansas is hoping that most alternative asset management transactions will go through vehicles in the state of Kansas, managed by their state trust banks under this new legislation.

And we use that capital then to provide liquidity to general partners and limited partners out of their venture funds and private equity funds.

And we also do the more popular route here in recent years which is fund restructures, where the funds reach the end of their life and the general partners need to provide liquidity, but the investments just are not ready to be harvested yet. We've provided quite a bit of liquidity to a variety of different venture funds, as well as leveraged buyout and private equity funds. Over this past couple of years, we see that there is more and more of a higher demand.

I'm very happy to be here, and happy to talk about the history and the current state of providing liquidity and conducting secondaries for venture capital opportunities and buyout opportunities.

KENNY: Absolutely brilliant. David, do you want to do an introduction as well?

DAVE MCCLURE: Yeah. Great to see all the folks here, who are actually a bunch of people that I haven't caught up with in a while. That includes John Stokes and David Blumberg, and several others who are entrepreneurs that we've invested in over the years, and some are actually recent LPs and customers too.

I've been in various roles in Silicon Valley for the past 30 years or so, as a software developer and an entrepreneur. I've run conferences and user groups for many years with O'Reilly and other folks. I worked at PayPal about 20 years ago prior to the IPO and acquisition by eBay. I met a lot of amazing people there who went on to start other things that are way more accomplished than we'll ever do. These were people who started LinkedIn, YouTube, and Yelp, and several other companies.

I started doing angel investing when I was at PayPal in around 2004, mostly on the side. I was following in the footsteps of guys like Reid Hoffman and Peter Thiel, but with a few less zeros at the end of my checks. I initially got to invest in some really great companies like Mint.com, SlideShare, Mashery, and a bunch of others.

And then, as I was trying to start my own fund in 2008, which was not the best time to start a fund because there was something else going on at the time called the global financial crisis. So I ended up going with Plan B, which was working with Sean Parker and Peter Thiel at Founders Fund for a few years, helping invest money out of their second fund, which actually did quite well.

I believe Founders Fund II is likely to be a 20x fund, with companies like SpaceX, Airbnb, and Palantir. The 3 million or so that I invested there ended up returning about 200 million. I was very fortunate to invest in a bunch of companies pretty early, including Twilio, Credit Karma, SendGrid, and Lyft, among others.

A few years after that, about 10 years ago I started 500 Startups. Like the name suggests, we invested in a lot of companies. When I left a few years ago, we had invested in about 1,800 companies across the first four funds. Now, I believe they've invested in 2,500 companies and have close to 2 billion under management.

What I'm doing now with Practical is a lot different than 500 Startups. We make one or two decisions quarterly, investing and buying secondaries. We also do company level deals, but most of what we do is buying out existing positions in funds from either LPs or GPs. We try to offer liquidity where there isn't much.

For those who are familiar with the secondary market, most of that is in the PE world, or private equity world. And for those who are familiar with it, in venture capital, most of that happens at the company level. But what we try to do is find microVC funds under $100M in size that are doing well that are about five to 10 years old and find LPs and GPs who want either full or partial liquidity and offer them a solution to get some. I'll leave it at that for the moment.

AYLA KREMB: Beautiful. That leads us to the topic at hand. Not everybody has had a chance to play with secondaries, so what is it? What does it mean? How does it work? Maybe we'll have Brad kick us off.

BRAD: Okay. The secondary industry really began in 1992 by a family office in Pittsburgh, who had been some of the founders of funds, like many of the folks that joined this webinar. Kleiner Perkins is one of the first that the family had invested in. Eventually, the portfolio had matured, and they wanted to take capital off the table. They invested quite a bit. And so, in 1992, the first series of secondaries were completed. It was about a $250 million transaction.

That was funded by AT&T Pension Plan as the lead, and a number of other pension plans. That was the first time we saw how limited partnership interests in venture funds could be sold before they were fully realized and liquidated. It woke the industry up because the industry at that point in time of investing in the space was in the neighborhood of being over 12 to 15 years old.

The true fund investing industry got its legs in ‘92 and began to grow in the mid ‘90s. By 1995, we had several firms that had entered the industry. That family did the first one, and helped to sponsor the first firm in the industry, which was called Paul Capital.

Phil Paul was the one who perfected how you valued a limited partnership, the type of purchase and sale agreement you needed to transact the selling of that interest, as well as private company shares, because that family had a series of co-investments directly in companies.

He started to work through how you dealt with the issuers of those shares in order to be able to trade them, and the business began to evolve from there. Today, it is a $110 billion industry. It's an enormous industry, of which the average transaction size in the private equity side, as Dave said, is $162 million.

That is done on the private equity side. On the venture capital side, it's much smaller in scale. About 16 firms in the industry do about 80% of all the transactions that are completed. And so, the goal is to help the limited partner be able to withdraw capital cash or be able to re-allocate to meet other demands that they may have to meet a new opportunity.

KENNY: That's great, appreciate that. I didn't realize it was that concentrated. Dave, do you have anything you want to add on your part there?

DAVE: I won't try and second guess Brad's experience in the secondary market. I will share a quick screenshot, though. These visuals show what Brad was talking about. It shows the beginning from the ‘90s, but it also shows from the 2000 timeframe. There has been a huge growth in the secondary market in the private equity industry. That's probably close to $100 billion dollars on an annual basis, but maybe not so much last year because of COVID.

We're seeing really huge funds like Coller Capital, Lexington, and many others that raised billions of dollars just in a single fund. Some of the transactions they do in buying secondaries are huge. They make hundreds of millions of dollars, to even single digit billion dollar deals in many cases since 2000, which was punctuated initially by the dot com crash, the global financial crisis, and some of the other dislocations in the market back around 2008 to 2010.

It's been growing quite actively in the last five years or so in particular. We have a lot of retail platforms that have come onto the scene. Some of the platforms you guys may probably have heard of are Forge and SharesPost, which have now merged. Another retail secondary platform is EquityZen, a company that came through 500 Startups. And there is also Carta, which runs Carta X and most notably did a secondary of their own company on their own platform, just a few months back.

More recently, we've seen lots and lots of retail buyers of secondaries. Typically, these are in large companies that are already past the unicorn stage, which already have several billion dollars, or in some cases, 10s of billions of dollars. What is less well known is the VC fund secondary business.

That is an area that we specialize a little bit more in, which is probably less than 15 to 20% of the overall venture capital secondary market. It's amazing. You wouldn't really think that a market you've never heard of before could be 100 billion dollars. But like the PE secondary business, we think the VC secondary market is on its way to becoming a $100 billion business.

We also believe the VC secondary business for fund interests, which is kind of small right now, is going to be at least tens of billions of dollars. This chart [see Figure 3 in Appendix] shows the trajectory of a VC fund over a 10-to-15-year period, particularly focusing on a seed stage fund as it develops.

Now, in the first five years, a lot of those funds tend to be a roller coaster. There is a lot of failure along the way. Hopefully, after 5, 6, or 7 years, some of the winners start to emerge from those portfolios, and we start to see companies that are Series B, C, and D emerge. Maybe a few would even IPO down the road.

KENNY: That's great. Dave is one of the only two people who have guested here twice, in the 68 episodes that we've done. And I will say that you clearly got a graphic designer for the slides this time. So kudos to you.

DAVE: Yeah, it's not my usual red bold font slides. It's a little bit prettier, I think. Last time I had a big picture of a cat riding a unicorn with a shotgun. That's more of my usual fare for slides.

KENNY: Dave, I know you're only a year or two into it, but where are you seeing your opportunities, and your deals? Is it all really Silicon Valley based? Or are you seeing that changing in the post pandemic world?

DAVE: Because we're focused on venture capital more than private equity, our focus tends to be in the U.S. and within Silicon Valley. But because of the work we did though with 500 Startups (which was all over the world), we do see a lot of opportunities not just in the U.S., but in many places around the world.

I would still say that most of the activity that we're doing with secondaries involves looking at micro VC funds that are between five to 10 years old, or are more mature.

That market for micro VC activity started happening in Silicon Valley about 10 to 15 years ago. That was when firms like First Round Capital initially came into that space, and others as well. And then, that trend accelerated in other places around the world. Today, you have a lot of smaller funds active in Western Europe. That started happening about 10 years ago.

You also have a lot of funds in Southeast Asia, particularly in India, since seven or eight years ago. More recently, we've begun seeing the trend across emerging markets around the world. I'm weeding out China, which is the other big part of the world that probably has a lot of luck that we don't. Within venture capital, the things that we've been looking at are maybe a little different.

A lot of the industry in secondaries, again, is focused mostly on the company level. That has really grown substantially in the last five years in the U.S., both in the professional world, as well as the retail sector, to the point that now, lots and lots of people are buying and selling interests in individual companies through brokers and on platforms.

Most of what we do isn't at the retail level, though. We're talking directly to general partners and limited partners of funds and buying out interest particularly in those funds before they've really gotten to maturity. So, we're a little bit more specific. Most of our activities at the moment have been in Silicon Valley. However, several portfolios we've been looking at are in different parts of the U.S., and a few are in different parts of the world.

AYLA: This brings up another question. How do you actually value the assets that a GP or an LP might hold in a fund? How do you approach the valuation process especially if there hasn't been a recent exit within the portfolio, etc.? Brad, you want to speak on that one?

BRAD: Sure. In Beneficient, we have two groups that do the evaluation process on every fund. One group does your traditional underwriting from a fundamental standpoint. We have a scoring system that we go through to identify a rating or a score for each of the individual funds that we're taking a look at.

The scoring system is based on the underlying holdings and the capability of the general partner to manage the holdings that's currently within the fund, as well as the track record of the general partner to harvest those holdings over time within the fund constraints.

Then, we have a second group that is a risk management group. In the underwriting group we have about 35 people. In the risk management group, we have about 15 people. They're all very talented individuals. Ten of them are Python coders. Five of them have PhDs. The team creates a series of technical models. Because now that we have so many companies that are startups, and that are new private companies, there are lots of different benchmarks and experience curves that history has in our data systems.

We can take a look at a company through our data systems and match it up to other characteristics of companies we've held in the past. We can get ideas of what the potential valuations of those companies can be through iterations of various algorithms to do a calculation on a technical basis. And then, that technical calculation by the risk group is matched up with the underwriting, with the fundamental evaluation, and a value is then wrapped up.

That process I just went through typically takes our team about 20 days. There's an additional 10 days that is required for us to be able to collect the information that's necessary to undertake that 20-day process. So, it takes us about 30 days for those teams to be able to arrive at the values for the holdings of somebody seeking liquidity.

KENNY: Great. That's pretty impressive. You can turn that around because Lord knows there's a lot of information asymmetry in these types of opportunities and getting that information and digesting it in 30 days is pretty good.

BRAD: One thing I want to add. As I said before, we're like a haystack. Secondary providers are all a little different. We're like a haystack because we're one big, continuous portfolio. And so, when we make mistakes in a portfolio, the mistakes go two ways. Because every time we do a value, it's not right. No value we arrive at is right. Everything I just told you, it’s not right.

And so, what our systems do is try to create a haystack where you're wrong low, and you're wrong high. It gets you to pretty close within a 95% confidence ratio of being right in the aggregate. And so, we really look at having what we call right sizing the haystack, where we always right value the haystack. If there is any one straw in the haystack, they're wrong.

DAVE: Maybe I could jump in with my perspective on how we figure out our valuation. Most general partner quarterly reporting is going to be very optimistic. And for people who are not familiar with how that works, even for audited funds, you will typically have a conversation with an auditor on an annual basis to review the valuations for your portfolio, and you have to justify what those valuations are based on, at the company level.

Typically, they're based on the last round financing for that company, and that is reasonably valid within one to two years of that financing. But it may not be all that valid if it takes longer than that. Valuations could be substantially higher or lower than those, in some cases where companies may be doing well and haven't raised capital for three, four, or five years, the valuations on the books could be quite stale and quite low.

As an example, we were an investor in a company called Udemy, which many of you may be familiar with. Udemy raised capital about a year ago at about a $3 billion valuation. But prior to that, it had not raised capital for five years, and was valued at a very substantially lower amount. On the flip side, there are many cases where a particular valuation for a company might not have been raised for many years after that. They might still be alive, but they may not be growing or doing very well.

In those cases, the valuation could be quite a bit more than the company's worth. In many cases, they may be worth zero. I'll just briefly share one more visual to give people a sense of how we think about this. For folks who are familiar with my nicknames for portfolio companies, we think about portfolios in three groups. Those are unicorns, centaurs, and horses. Among those three groups, horses are the least magical.

These are typically companies that are less than $100 million in value, probably with less than $10 to $20 million in revenue. And they may or may not ever get to any kind of exit. The next group is centaurs. This consists of companies that are probably between 100 million to a billion, who we think have a chance of going to an exit. But unless they grow larger, they may not go to an IPO. So we might have some optimism of whether they get to an exit, but it may not be right around the corner.

And then of course, there's the unicorn group, which many of you are familiar with. With these companies, there is probably at least some possibility of getting an exit, an acquisition, or an IPO. Once we start a segment by size or revenue, we then do an analysis of how those companies might be growing. Most of what we're looking at is their current size and their potential growth over the next few years.

If you look at that upper right-hand corner where there are fast growing unicorns, that's where most of the individual company secondary is going on. And as you invest, you might be paying a premium for those assets. For most everything else, you're probably paying some discounts to the value that was raised last. Some companies might still be growing, some may not. We try and figure out what that overall package of goods looks like.

There usually is not a lot of discrepancy in how we think about valuing unicorns, and there's probably more data about when those financings were done and what people's opinions on the market are. For the centaurs and horses, there's usually quite a bit of difference about what the value is worth. Although, again, for horses, it's probably close to zero.

When we think about looking at how GPs report on their portfolios, there are probably a lot of things that they have marked up that are in those lower two categories of centaurs and horses that we don't always believe. Everything that's in the horses category would probably be reduced to zero. For everything in the centaur category, although most other folks would put it at zero, we will probably have a process to evaluate where it's around 50 cents of the dollar, or maybe slightly more or less.

That all typically results in us discounting overall portfolio values by anywhere from 20 to 40%. That may sound dramatic, but that's probably based on our skepticism about how much of that portfolio is really completely valued as a good long tail versus bad long tail.

Appendix

Images Courtesy of Practical Venture Capital

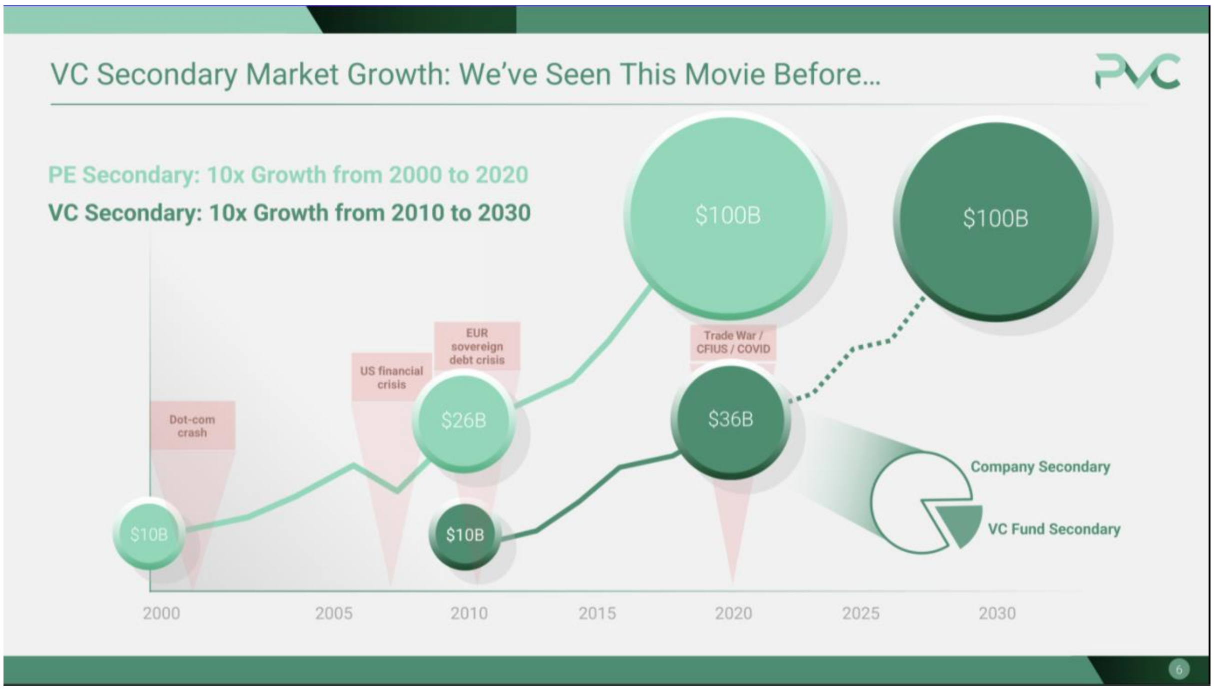

Figure 1 - VC Secondary Market Growth

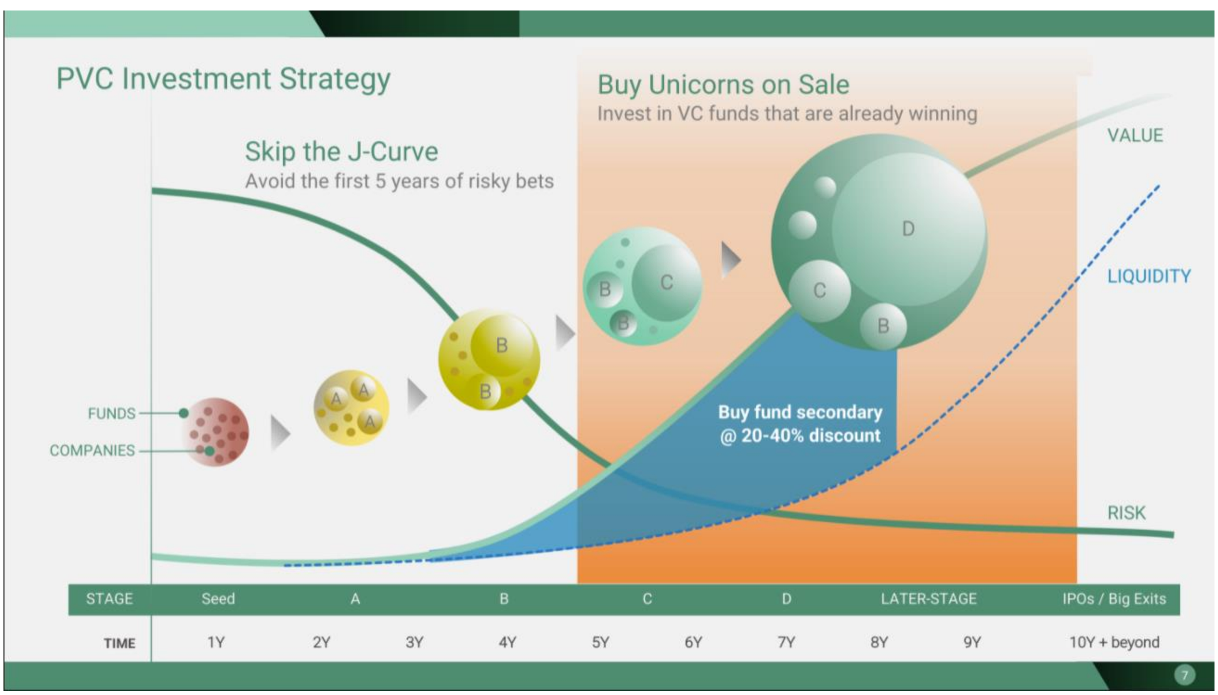

Figure 2 - PVC Investment Strategy

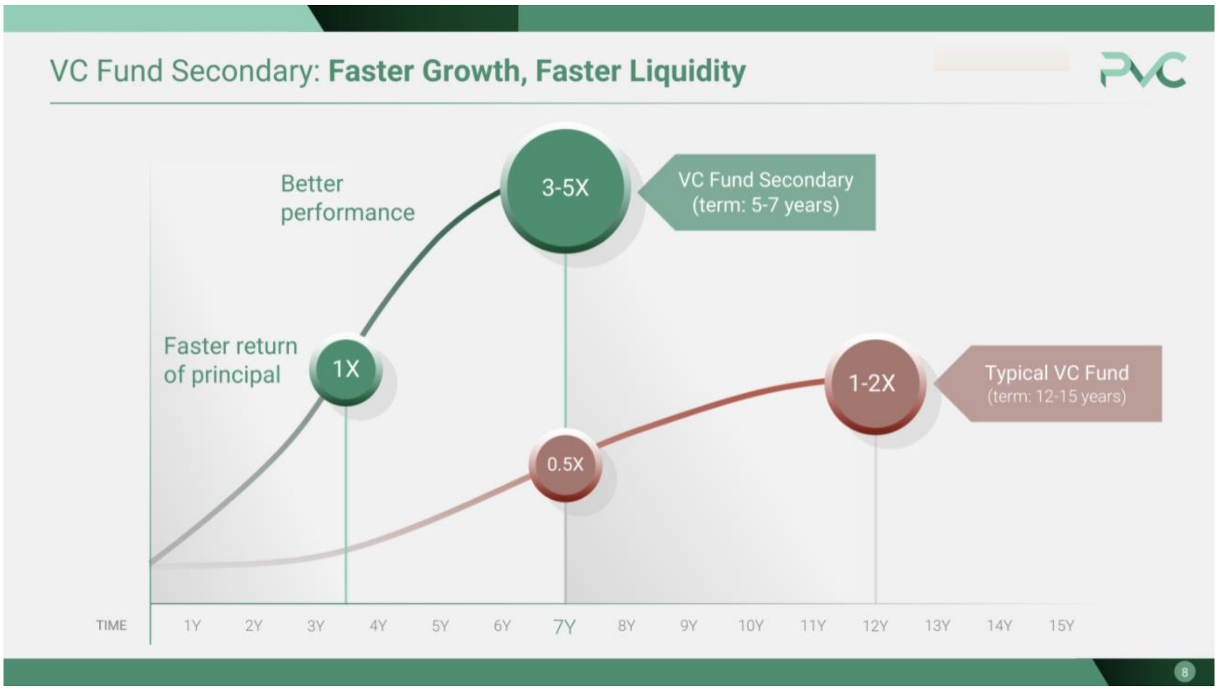

Figure 3 - VC Fund Secondary

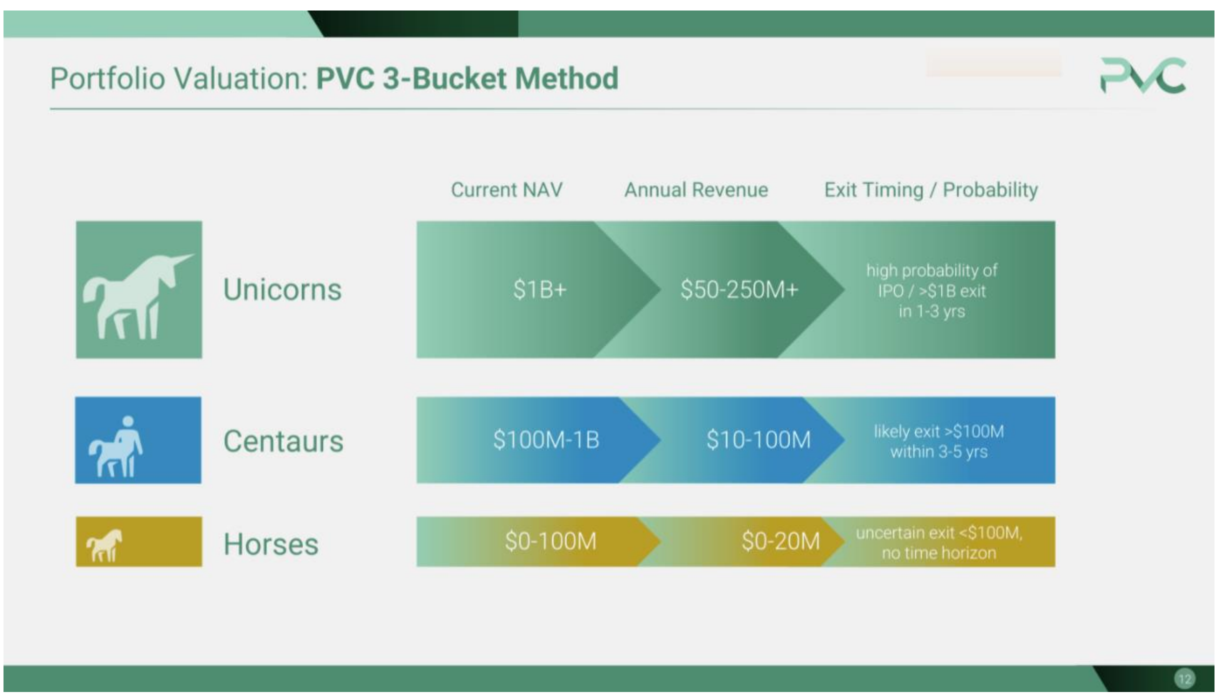

Figure 4 - Portfolio Valuation: PVC 3-Bucket Method

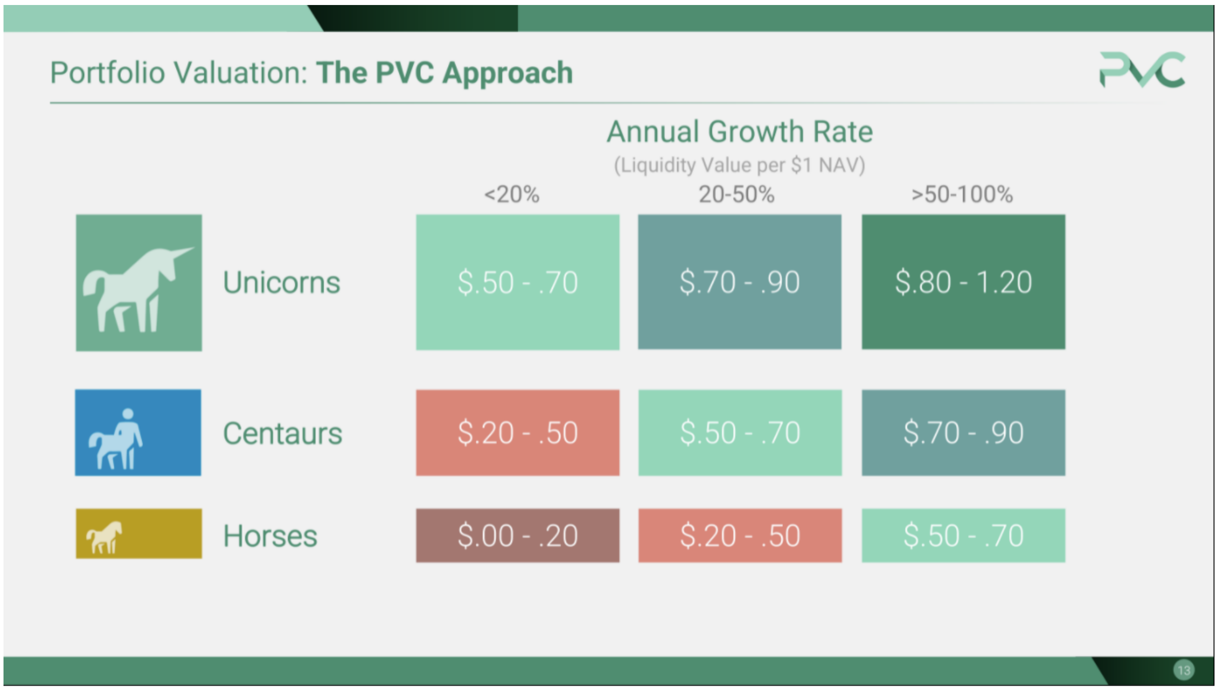

Figure 5 - Portfolio Valuation: The PVC Approach

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Corporate Director, CME Group

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