NASDAQ Private Market™

What's A Structured Liquidity Program?

A guide to understanding structured liquidity programs for private compaines

Staying private longer

Since the burst of the tech bubble in 2000, companies have been staying private longer. According to the National Venture Capital Association[1], the mean time to exit for venture-backed IPOs increased from 3.7 years in 2000 to 8.1 years in 2013. In addition to cyclical changes, there have been a number of structural changes such as the increased costs due to the Sarbanes-Oxley Act of 2002 and reduced research coverage of small cap stocks due to the Global Settlement of 2003[2].

With the passage of the JOBS Act in 2012, private companies can now have up to 2,000 shareholders not including employees. This is an increase from 500 shareholders including employees prior to the Act, a limit that impacted a number of high profile tech companies decision to go public including Microsoft, Google and Facebook[3]. This new flexibility has allowed companies to stay private longer with some even choosing to stay private indefinitely.

Putting real value in stock options

While staying private may enable companies to make more long term decisions rather than focus on quarterly earnings, it does raise a separate issue of shareholder liquidity. Especially in a tight job market, like the one we are currently experiencing in Silicon Valley, the lack of liquidity can make the difference in an employee's choice of joining a startup vs. a public company.

Today, more and more private companies are turning to Structured Liquidity Programs (SLPs) to address shareholder liquidity needs while continuing to remain private. An SLP is an organized process to enable a large number of existing shareholders to sell all or a portion of their shares to a pre-determined group of new investors. Since the new investors are purchasing existing shares in the company, the transaction is non-dilutive to existing investors in most cases. By providing liquidity through an SLP, a company can put real value in their stock options while remaining private.

Finding the buyers

More and more investors are turning to the private market for new investment opportunities. Historically public investors, such as mutual funds and hedge funds, are now active participants in the private company market. With a wider range of potential investors, many companies are choosing to work with investment bankers to help them navigate the different sources of capital available to them. It is important to ensure that any new investors are aligned with the company's long-term goals including the timing of a public offering or potential acquisition.

Structuring an SLP

SLPs are often structured as a tender offer where the buying group offers to purchase up to a certain number of shares at a fixed price. Tender offers are well-defined transactions under Regulation 14E of the 1934 Securities Exchange Act that must be held open for 20 business days.

By working with the company to achieve a specific goal, the buying group may include limitations on which share and option holders are eligible to participate in the offering and the maximum percentage of their vested holdings that they can sell. For example, if the company's goal is to increase employee retention, the buying group may restrict the offering to existing employees and only allow them to sell a percentage of their holdings. This structure can provide a valuable benefit while ensuring that the employees stay aligned with the company's long-term goals. In other situations, the company may want to reduce their number of unaffiliated shareholders, so the buying group may allow former employee shareholders to participate on an all or none basis, thus removing any participating shareholders from the company's cap table.

In some cases, a company may choose to separate the timing of the sale of the shares to the new investors from the SLP by structuring the offering as a repurchase. In this scenario, the company would issue shares to the new investors and then use the proceeds to repurchase shares from their existing equity holders. The key benefit to this structure is the increased flexibility the company has regarding the timing of the two transactions. However, since there are two distinct transactions, the costs of this structure can be greater.

Impact on 409a

Due to the company's direct involvement, a repurchase may have a greater impact on the fair market value of the company's shares during their next 409a valuation. Categorizing the difference between the purchase price and the current fair market value as compensation can reduce this impact, but has negative tax consequences for the selling shareholders. A third party tender offer usually has less impact on the fair market value, but a company should always discuss the impact of any SLP with their valuation firm prior to executing the program.

Information disclosure

In all SLPs, the company should carefully consider what information they will provide to transaction participants. The goal should be to ensure buyers and sellers have symmetrical access to necessary information to make an informed investment decision. The company also needs to company with Rule 10b-5 of the 1934 Securities Exchange Act, which prohibits the purchase or sale of securities while in the possession of material, non-public information about the issuer. The adoption of an insider trading policy can help to mitigate this issue.

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Summary

As companies are staying private longer, they need a new solution to provide liquidity to their equity holders. A Structured Liquidity Program can provide an excellent way to provide liquidity through a company-controller transaction that ensures the alignment of interests of all parties.

Citations

1. 2014 NVCA Yearbook, Figure 4.03, page 73: http://nvca.org/?ddownload=676
2. Analyzing the Analysts: A Survey of the State of Wall Street Equity Research 10 Years after the Global Settlement: http://ir.bdcv.com/sites/keatingcapital.investorhq.businesswire.com/files/doc_library/file/Analyzing-the-Analysts-01-22-13-FINAL.pdf
3. Killing the 500-shareholder rule, Fortune, November 8, 2011: http://fortune.com/2011/11/08/killing-the-500-shareholder-rule/