



# Nasdaq Private Market: An Introduction to Secondary Auctions for Private Companies

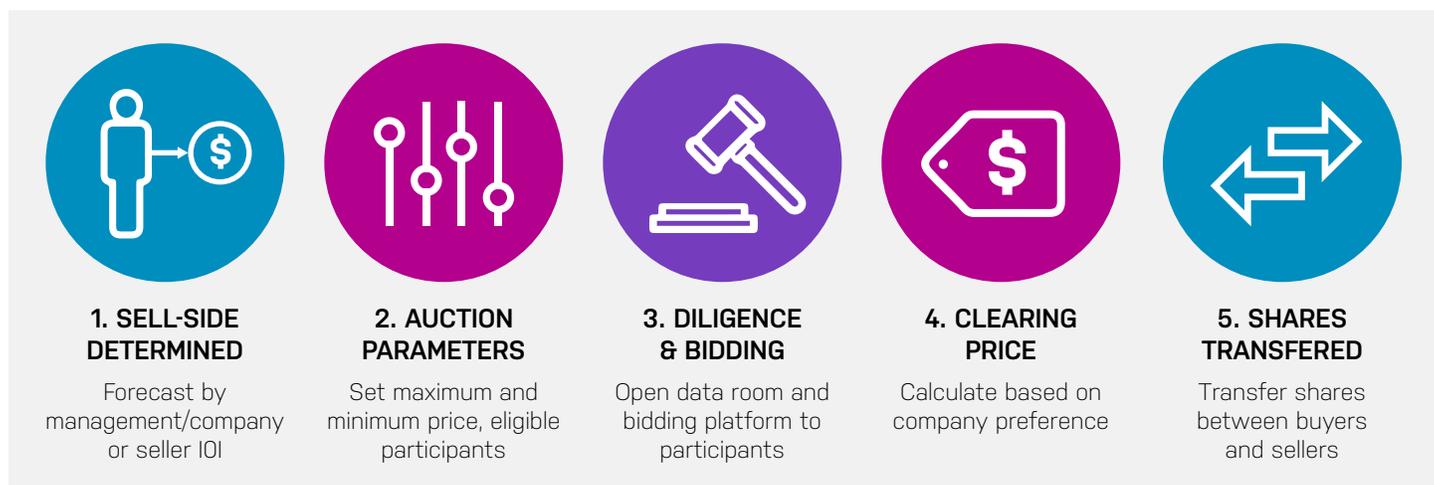
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Nasdaq Private Market's mission is to reduce barriers to accessible liquidity for private companies and private funds. For private companies, we are experts in facilitating private secondary transactions and have facilitated over 230 transactions in the last 5 years. The transaction type that dominates the private landscape is called a "tender offer". A private tender offer generally follows certain criteria (e.g., 20 or more sellers, open for 20 business days, etc.). According to the SEC, a tender offer is a broad solicitation by a company or a third party to purchase a substantial percentage of a company's Section 12 registered equity shares or units for a limited period of time. The offer is at a fixed price, usually at a premium over the current market price, and is customarily contingent on shareholders tendering a fixed number of their shares or units<sup>1</sup>. There may be more considerations in order to satisfy all the requirements to a tender offer, and we would highly encourage you to speak with your legal counsel regarding them.

For the purposes of this report, we will include company buybacks with third party tender offers since the mechanics of these transaction types are similar. Most private companies and their legal counsel have become comfortable with this transaction type for several reasons, including its predictability and structure. **However, as companies stay private longer, they have begun to search for alternatives to the tender offer that provide competitive pricing and potentially allow company shareholders to be more involved in the transaction itself.** This brings us to auctions. Auctions have existed in the public markets for decades, and have been used in various forms – from Dutch auctions for public offerings to call auctions used by most major stock markets to open and close trading for the day<sup>2,3</sup>.

The private markets have not used auctions to nearly the same extent, especially regarding secondary transactions for private company shares. But that is starting to change. With dry powder continuing to remain at all-time high levels, growth equity and venture capital investors are looking for more opportunities to deploy their approximately \$145 billion of capital<sup>4</sup>. This competitive landscape lends itself perfectly to the auction format. In 2018, Nasdaq Private Market began exploring its capabilities in private secondary transactions to include several different types of auctions, in addition to those we have run for our clients in the past. We are able to leverage our legal expertise and operational excellence to successfully execute these new and innovative program structures for the private markets. While there are some risks to holding auctions compared to a standard tender offer or secondary transactions, we believe that these auction programs may have benefits for the sponsor company, shareholders, and the buyers, and could change how private companies hold secondary transactions in the future.

## The Private Company Auction Process



## AUCTIONS OVERVIEW

In its simplest form, an auction is a process in which potential buyers place bids on assets or services, with the intention of becoming the highest bidder and purchasing the asset or service for that amount<sup>5</sup>. From there, auctions can be customized to change the dynamics of the transaction. Bids can be open or sealed, the winning price may end up being the second highest price bid, sellers may provide input on price per share and quantity willing to be sold, and more. Simple auctions typically take four different forms: English, Dutch, first price, and second price auctions.

**Table 1.0 – Simple Forms of Auctions**

Auction Type	Description
English	Price increases until one bidder is left; remaining bidder wins and pays the highest bid amount <sup>6</sup>
Dutch	Prices decrease until a bidder accepts the price; this bidder wins and pays price at acceptance <sup>2</sup>
First Price	Each bidder submits a sealed bid; highest bidder wins and pays the highest bid amount <sup>7</sup>
Second Price	Each bidder submits a sealed bid; highest bidder wins and pays second highest bid amount <sup>7</sup>

Nasdaq Private Market can run different variations of these price discovery processes, including auctions that mimic public offering Dutch auctions whereby the clearing price of the secondary transaction is calculated after collecting all bids, in a sealed manner, to determine the highest price at which the total projected amount of shares for sale can be sold. This is our "Buy-side Auction" process, and we are also exploring modified Dutch auction processes in which both Buyers and Sellers enter bids and asks, respectively. Additionally, our technology platform has the ability to hold many different types of auctions, including first price auctions for investor and founder blocks, and we can project sell-side demand prior to the auction processes through our Seller Indication of Interest (IOI) collection process. NPM is also able to customize auction programs to meet a company's specific needs. Details such as the timing, the price collars, and the number of participants can be adjusted and tailored to adhere to an individual transaction's requirements. We can also introduce additional buyers to a competitive bidding process to supplement any investors that the company may want to participate. Our network of institutional buyers are experienced in secondary transactions and many have dedicated funds ready to invest in private companies.

**Table 2.0 – Auction Types Supported by Nasdaq Private Market**

Auction Type	Description	Typical Use Case
Dutch	Bids and asks placed by buyers and sellers, one clearing price calculated for all participants	Companies looking to replace tender offers for secondary liquidity
Buy-Side	Sell-side demand projected by company, competitive bidding process by buyers followed by tender offer	High growth; many interested buyers; still adheres to tender offer guidelines
Seller IOI	Sellers enter asks for price per share and number of shares willing to be sold (prior to transaction)	Companies and executives who need to forecast demand for liquidity
English	Price increases until one bidder is left; remaining bidder wins and pays the highest bid amount	Investor or Founder Block Sale; Secondary Sales <\$10M
Custom & Combination	Customize price floor/ceiling, timing of bids/asks, seller eligibility, existing/new buyers, and more	All companies interested in secondary transactions

## ADVANTAGES & DISADVANTAGES OF AUCTION-BASED TRANSACTIONS

While tender offers have become widely accepted as the main type of secondary transaction for private companies, including an auction component to these secondary transactions or running a standalone auction may have even greater benefits and risks for all participants, including buyers. **Companies that run auctions can potentially benefit from competitive price discovery from sophisticated, institutional buyers.** This generally leads to a more transparent process for both buyers and sellers. Additionally, it provides valuable data points for those sellers who may not be eligible or do not elect to sell in the transaction. **The aggregation of buy-side demand may also lead to more price competition from buyers who may be willing to outbid one another to get their shot at investing in high growth companies.** A higher price is obviously advantageous for a seller, but may also deter some buyers from entering the process, which is why buyers traditionally favor one-on-one transactions that inherently leave room for negotiation around potentially more favorable price and investment terms for a buyer. A sponsor or issuer looking for less negotiation around terms (e.g., information rights) and price (e.g., price per share) may elect to have a standardized letter of intent signed by each buyer. This letter of intent would define the rights that would be given to each successful bidder upon completion of the transaction before placing bids to expedite the transaction process and focus more on the auction itself.

Depending on the structure, companies may also be able to carry out the entire auction in less time than it takes to hold a traditional tender offer, mainly due to the **20-business day mandatory tender offer window**. Companies looking for a quicker secondary may want to explore options for these types of auctions. In addition to the potential for a shorter transaction duration, **both buyers and sellers may get the added benefit of paying or receiving a price per share that is better than what they originally bid or asked, respectively.** There are many different types of clearing price calculations, and each type may be able to provide more advantageous pricing for clearing bids in certain auction types – potentially leading to a benefit for both sellers and buyers. **Auctions also provide the same level of customization, if not higher, than tender offers.** Companies can name price floors and ceilings to control bidding, they can project or limit the amount eligible to be sold in the transaction, they can permission certain buyers into the process, and they can control what information they disclose to all participants. Lastly, tender offers can include an auction component, thus bringing together the benefits of both secondary transaction structures.

Table 3.0 – Auctions Compared to Tender Offers: Potential Advantages and Disadvantages

	Auctions	Tender Offers
Advantages	<ul style="list-style-type: none"> <li>• Offers potentially more competitive bidding process</li> <li>• Provides additional data points for future transactions, direct listings, and IPOs</li> <li>• Creates a centralized, standardized manner to collect bids</li> <li>• Creates a more market-driven price discovery process; more transparent clearing price calculations</li> <li>• Limits negotiations from third parties</li> <li>• No need for a lead purchaser to set price</li> </ul>	<ul style="list-style-type: none"> <li>• Traditional, standard method for secondary transactions</li> <li>• Most legal counsels have experience with these types of transactions</li> <li>• Provides a more linear approach to creating an offer price</li> <li>• Existing, proven processes in place can lead to more efficient transactions</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>• Certain auctions may be more complex and time consuming</li> <li>• Auction mechanics are new and must be thoroughly reviewed by legal counsel</li> <li>• Limited guidelines from legal experts can create ambiguity</li> </ul>	<ul style="list-style-type: none"> <li>• Uses a "black box" approach to price discovery</li> <li>• Lack of transparency mainly benefits buyers</li> <li>• Potential for prolonged negotiations</li> <li>• Difficult to forecast the probability of successful transaction prior to closing</li> </ul>

Even though auctions have many potential benefits for transaction participants, there can be drawbacks. For certain price discovery processes (e.g., buy-side auctions), sellers may have little to no input on the final transaction price and may feel "left out" from the price discovery process, though they also have the option not to accept the price identified. If sellers are not included in the process ahead of the auction, it may be difficult for companies to forecast sell-side demand from their shareholder bases. Additionally, there is a risk of a price mismatch between buyers and sellers during an auction. Buyers may not incorporate sentimental value or sweat equity into the price like sellers may, thus leading to low bids and high asks. For dual-sided auctions with a single clearing price, the auction may be undercut by one large seller if that seller decides to sell for a very low price, bringing down the final clearing price for all sell-side participants and offering less liquidity than may have originally been planned. **As companies decide to run auctions, it is important to find ways to mitigate the risks caused by the inherent disadvantages in different auction structures.**

NPM has developed a solution to alleviate some of the stress private companies experience around making sure sellers do not feel "left out" of the price discovery process. The NPM solution is to hold a Seller Indication of Interest process before the auction. The Seller IOI process would allow eligible sellers to enter a proposed quantity and price at which they would be willing to sell shares, all on a controlled platform that can be accessed only by company-permissioned sellers. In addition to providing sellers with a voice in the pricing process, it can also potentially help companies with forecasting the sell-side participation in a secondary transaction. NPM can provide aggregated information around participation rates and amounts tendered from past transactions, but the most accurate way for an issuer to forecast sell-side demand is to ask the sellers themselves. In order to address possible price mismatches by buyers and sellers, NPM allows companies to implement price floors and/or ceilings for transactions. This gives "guidelines" for pricing for both buyers and sellers and can lead to more reasonable bids that are more likely to match in the clearing price calculation. It also limits the downside for potential sellers in case there is a large seller who can sway the clearing price with a very low ask.

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#### **A CASE STUDY: NPM'S BUY-SIDE AUCTION MODEL\***

In 2018, Nasdaq Private Market began the creation of a new transaction model while working with a private B2B company valued at over \$1 billion. The resulting model was what we now call the "buy-side auction", and led to a successful transaction in which winning bidders were able to purchase shares in the company and provide liquidity to employees eligible to sell in this transaction<sup>†</sup>. The secondary transaction closed just a few months after their most recent round of funding and resulted in a final clearing price above the last round's price per share of preferred stock. NPM, along with our client, identified both existing and new investors that included sophisticated venture capital investors, institutional funds, and Fortune 500 companies with a collective AUM (assets under management) of more than \$100 billion. The company's growth, executive team, and current lineup of investors contributed to the company's ability to attract new investors and saw an increased appetite for additional investment from existing investors.

After the buyers had been assembled and permissioned by the company to participate, disclosure materials were shared via NPM's confidential dataroom. Buyers were given two weeks to review the materials and had the option to use the week-long bidding process as additional time for research and meetings with the company. Calls and meetings with all interested buyers

were conducted in order to provide buyers with information they deemed to be sufficient to make an investment decision. The company had originally forecasted the maximum sellable amount (e.g., 10,000,000 shares) and elected to only set a price floor that bidders would have to bid at or above. Armed with this information, buyers participated in the seven day bidding process to enter bids for a number of shares at a particular price per share (e.g., \$20/share for 1,000,000 shares).

During the bidding period, NPM received several bids from a majority of the buyers, exceeding demand projections by 95% (e.g., 10,000,000 projected, but 19,500,000 shares bid for). The clearing price was calculated using the lowest bid that cleared the maximum projected sellable amount. This resulted in a clearing price that was calculated at a premium to the last round of preferred. In this particular transaction, several of the buyers submitted winning bids and were allocated share amounts according to their bid sizes. Buyers with winning bids were then permissioned into the tender offer process where the company's eligible shareholders were given the opportunity to sell their shares at the clearing price. The entire process lasted approximately eight weeks. **This transaction ended successfully by providing eligible sellers with access to liquidity at a competitive offer price and giving investors the chance to invest in what they believed was an attractive investment opportunity.**

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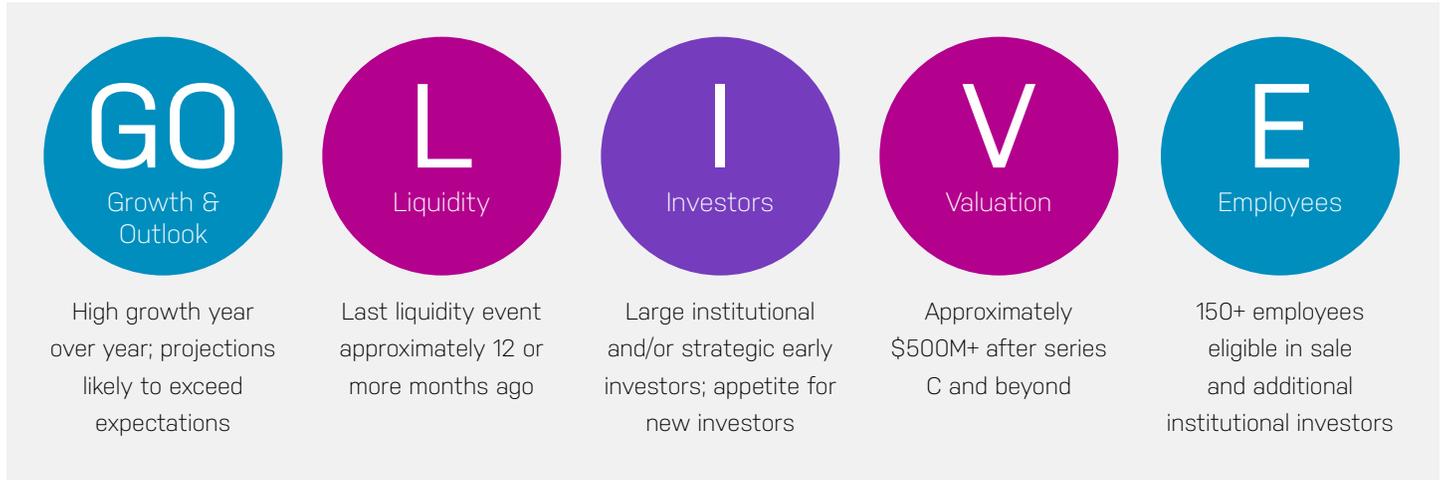
\*Note: all figures provided are illustrative only and are not indication of future performance or results

<sup>†</sup>The results of this transaction are not indicative of all results for other transactions of this type. The bid prices in other transactions may be placed at a discount, and sellers may not accept these prices in the offer.

## CONSIDERATIONS FOR RUNNING AN AUCTION

As a leading provider of liquidity solutions to private companies, NPM is often asked about the right way to structure a transaction and which transaction types will work best for a particular company. The answer is: it depends. In addition to providing a high-touch, tailored experience, we also bring a host of business expertise and knowledge to every transaction we work on. One framework that we use to identify companies eligible to conduct an auction or price discovery process is our "GO-LIVE" framework (see Figure 1).

Figure 1 - Nasdaq Private Market's GO-LIVE Framework for Private Company Auctions



This framework provides a high-level benchmark for companies that may benefit from running an auction, but the numbers and guidelines are not determinant factors that would lead to a successful transaction.

**The main factor that determines the success of an auction is the demand (both on the sell-side and buy-side).** While we recognize that the sell-side demand is incredibly hard to project, buy-side demand can be slightly easier to predict. Generally, companies with high growth that have exceeded projections and continue to receive a great deal of interest from outside investors receive the most competitive bids during an auction. These companies are expecting continued growth and provide attractive investment opportunities for growth equity firms. Since growth is a strong driver of valuation, valuation is also an important factor for creating strong buy-side demand. Valuation provides an absolute benchmark for investors, in terms of fiat currency, and can be used in a number of investment criteria. With those factors in place, it is important to note that the most knowledgeable investors can be those existing investors in the company. Existing investors are often the ones who provide the most attractive bids due to their relationships with company leadership and understanding of the company's operations, financial health, and future outlook. This can give them a leg up over outside investors in the bidding process. However, eager outside investors that are willing to take on the diligence may provide additional upward pressure on the bids. Investors who may not have been able to participate in the latest primary round often serve as some

of the best bidders in a secondary auction (or any secondary transaction, for that matter). This may not be the case for all companies, though. If the company's main business is relatively complex or the market is very niche, there may only be a small number of bidders who have the knowledge and ability to perform the necessary time consuming diligence to make a viable bid<sup>9</sup>.

**One way to help investors make more competitive bids is for the company's management to hold meetings with the investors to answer any outstanding questions not answered by the disclosure materials provided at the beginning of every transaction.** These meetings/calls consolidate investors' questions and provide a channel to answer any outstanding inquiries. **Another way to expedite the process is to use standardized agreements and documentation so investors do not have to spend time drafting an offer to purchase or transfer agreements.** With investors putting in the work to place competitive bids and gather capital, it is important for the company to aggregate sell-side demand and educate eligible sellers about the process. Successful secondary transactions often have a "back-stop" in place to minimize the risk of undersubscription (selling fewer shares than what investors have bid for or what the company has forecasted to sell). We have seen a wide variety of methods for this back-stop, which can be in the form of early investors, founders, or former employees who may have higher sellable limits to fill those bids not met by existing employees.

As mega-rounds and VC funding continue to reach record levels, it is important to find avenues for these investors to deploy capital while bringing liquidity to private company founders and employees<sup>9</sup>. NPM believes the new, dominant form of secondary transaction will be the private company auction. **An auction can provide a centralized format for buyers to enter competitive, market-driven bids, while creating a transparent, beneficial path for sellers to receive fair prices for their equity.** Combined with a proven software platform and an operational team with more

than 230 plus transactions worth of experience, NPM can help companies provide liquidity in a manner that potentially brings the private markets more value and customization. Regardless of a private company's liquidity needs, the auction format has several advantages over the traditional tender offer structures, and NPM can engage with companies early on in the process to help avoid common pitfalls and maximize the likelihood of a successful auction.

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