Empirical analysis of observed Discounts in Secondary Transactions in New Age Companies

October 2024

EY

Shape the future with confidence

New age companies have complex capital structure

1

Most companies are predominantly funded by ordinary equity, occasionally supplemented by minor convertible instruments.

2

However, most new age companies tend to have complex capital structures, with a mix of equity and convertible instruments, incorporating diverse investor preferences. The equity capital is relatively a small portion, mainly held by founders, as against series of convertible preference shares, held by the investors who have come in at various stages of fund raising.

3

Preference shareholders typically have certain downside protection rights that are not available to equity shareholders. These rights often include liquidation preference and anti-dilution rights, which helps investors protect the original investment, especially useful in scenarios with high execution uncertainty.

A liquidation preference represents an investors' right to get his or her money back before the holders of common stock, which typically includes a company's founders and employees.

Anti-dilution right protects ownership percentage of a shareholder from being diluted by future rounds of financing, happening at a lower price per share than the original issue price to investor.

Example of fund raising through convertible preference shares

CPS Fund Raise: CRED

In September 2018, CRED raised INR1,800 million through the issuance of Series A CPS at a pre-money valuation of INR 2,400 mn.

In July 2019, CRED raised INR 8,300 mn through the issuance of Series B CPS at a pre-money valuation of INR 19,000 mn.

In January 2021,CRED raised INR 6,200 mn through the issuance of Series C CPS at a pre-money valuation of INR 47,500 mn.

In May 2021, CRED raised INR 15,600 mn through the issuance of Series D CPS at a pre-money valuation of INR 128,900 mn.

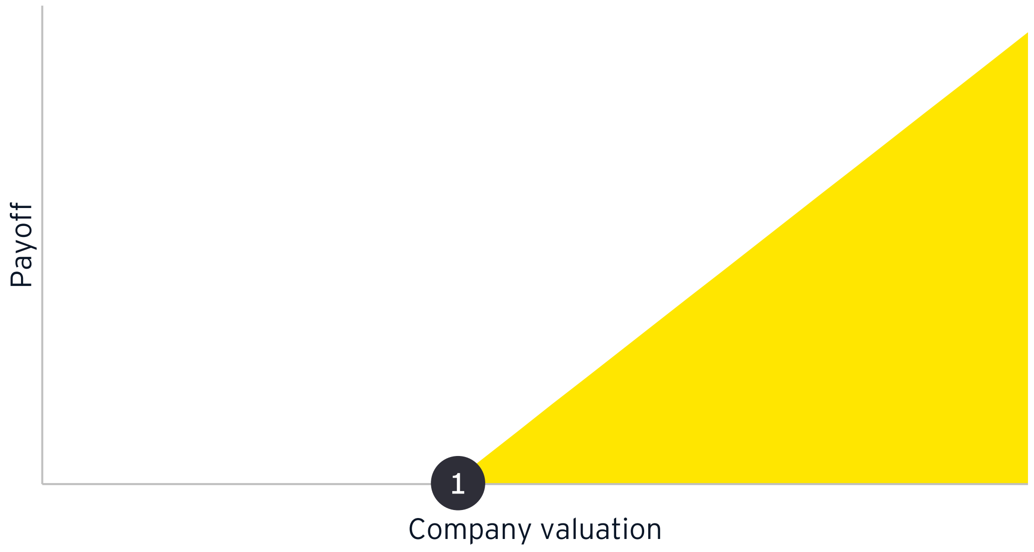
In May 2022,CRED raised INR 12,700 mn through the issuance of Series E1 CPS at a pre-money valuation of INR 260,500 mn.

In June 2022, CRED raised INR 6,200 mn through the issuance of Series F CPS at a pre-money valuation of INR 416,900 mn.

Source: Private Circle

Payoff for various shareholders (for illustration purposes)

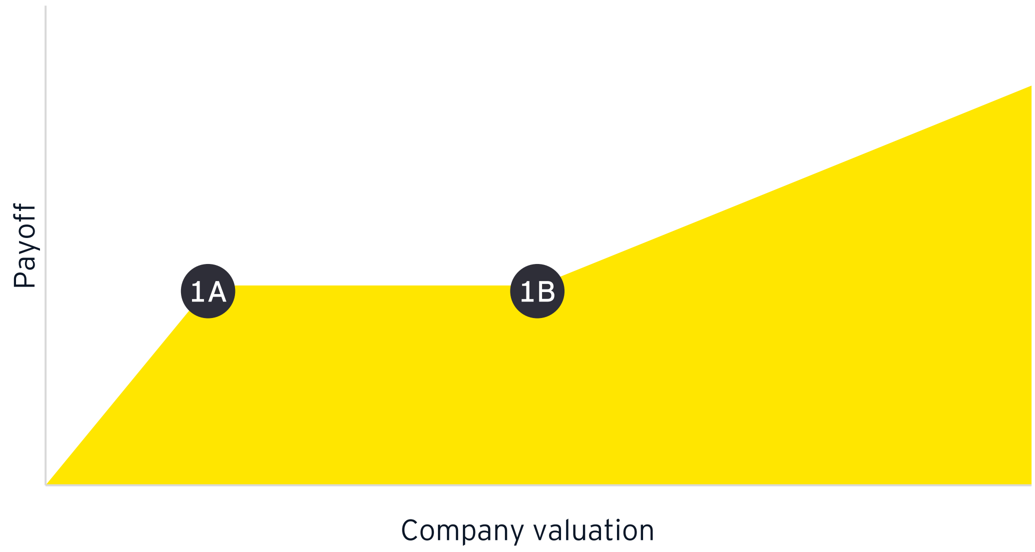
I. Payoff for Equity Shareholders



Inflection Point 1:

Equity shareholders receive proceeds after paying out debtholders.

II. Payoff for Preference Shareholders



Inflection Point 1A:

Valuation up to which preference shareholders' payoff increases, till they receive their original amount invested (i.e., Liquidation Preference)

Inflection Point 1B:

Valuation after which the preference shareholders will give up their LP right and convert their preference shares into common equity

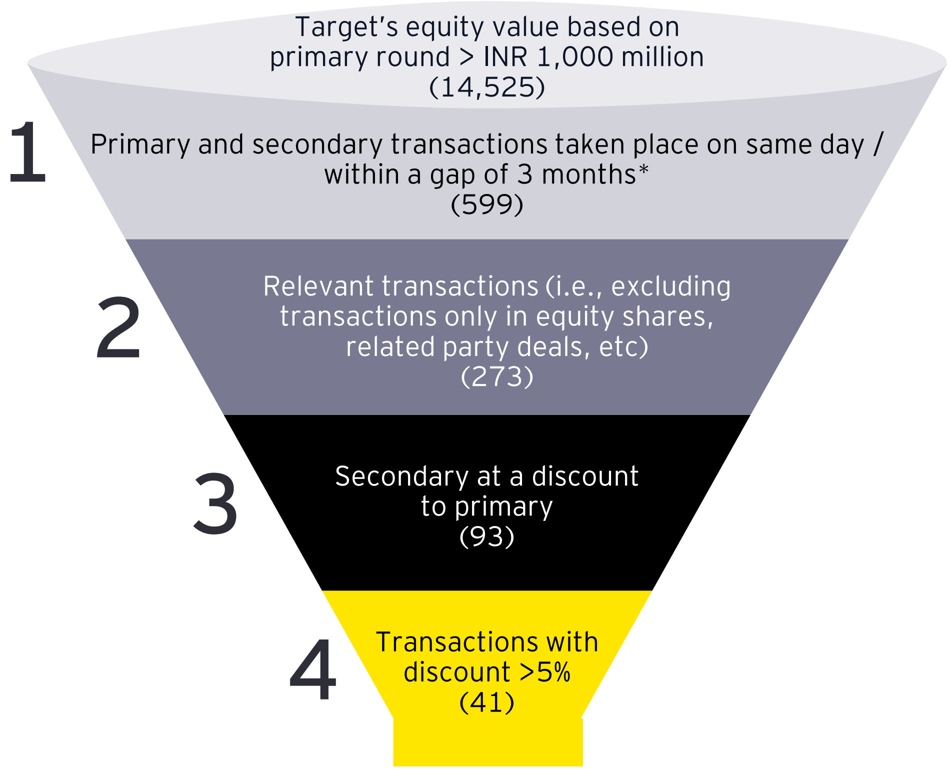
Note: Simplistic payoff chart assuming only equity and debt in case of I and only 1 series of convertible preference shares in case of II

Objective of the study

Objective: Do secondary transactions take place at a discount to primary transactions?

Approach: Selection criteria for concurrent primary and secondary transactions

- ✓ Period: 01 January 2019 to 30 June 2024
- ✓ Considered all types of transactions excluding M&A, IPO, primary and secondary transactions both classified as strategic transactions, debt funding, companies issuing ESOPs to its employees, and secondary transactions between related parties
- ✓ Target's equity value more than INR 1,000 Mn based on primary round
- ✓ Value of transaction (primary and secondary) more than INR 10 million
- ✓ Primary and secondary transactions occurred on the same day or within a three-month gap
- ✓ Combined various primary (or) secondary transactions with same price taken place within a gap of three months
- ✓ Transactions with <5% discount is considered as no discount to factor data discrepancy and materiality



*Primary transaction: Involves issuance of new series of shares to investors to raise capital. | Secondary transaction: This is between two parties involving sale of existing shares of lower series or common equity, with no fund flows into the target company

Source: Private Circle, EY Analysis

Summary results

1

Out of 273 transactions, ~85% of secondary transactions happened at same value as concurrent primary investments i.e., no discount#

2

Average discount of remaining 41 concurrent primary and secondary transactions - 20%

3

Discounts had reduced during COVID years: mean discount of 18% during 2020 and 2021 vis-à-vis 24% in other years

4

Discounts witnessed across all valuation sizes of the companies; albeit lower for smaller companies

5

Discounts did not vary on the basis of percentage stake transacted or the size of transaction

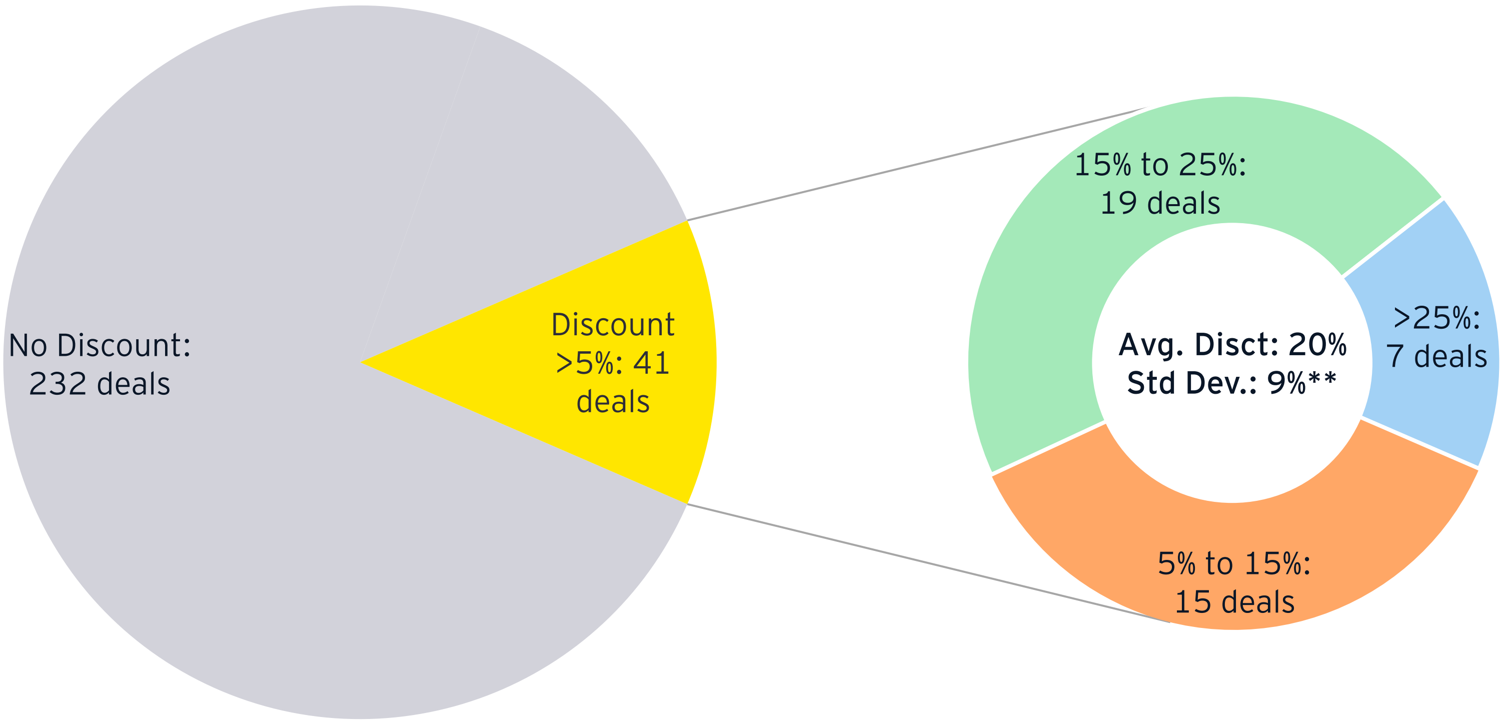
6

Profile of buyer (same vis-à-vis different) did not materially impact the discount

Minor discounts of up to 5% ignored

Average discount of 41 concurrent primary and secondary transactions (Post-Jan 2019) - 20%

Number of instances where primary transactions occurred in preference shares and secondary transactions happened in equity or lower series instruments



*No Discount includes secondary transactions which are up to 5% discount or at a premium over the concurrent primary transaction
**Standard Deviation of 9% implies the discount in transactions are in a narrow range
Source: Private Circle, EY Analysis

Reasons for transactions indicating no or minimal discount

Binary outcome

Expectation of eventual outcome is binary – either successful high-value exit or complete failure (i.e., no mid-value exits where LP becomes relevant). This is typically seen in early-stage companies

Probability of exit higher than fund raised

Exit imminent at value higher than the total fund raised till date. This is typically seen in late-stage companies

Investors have better LPs but lack adequate control

Late-stage investors having better LPs do not have adequate stake to control timing of exit event, hence they cannot enforce mid-value exit that could be beneficial to them

Steady increase in valuation

Value change over the years evolving smoothly rather than a sudden spike (eg. no riskier bets by later investors), thus reducing possibility of subsequent down rounds

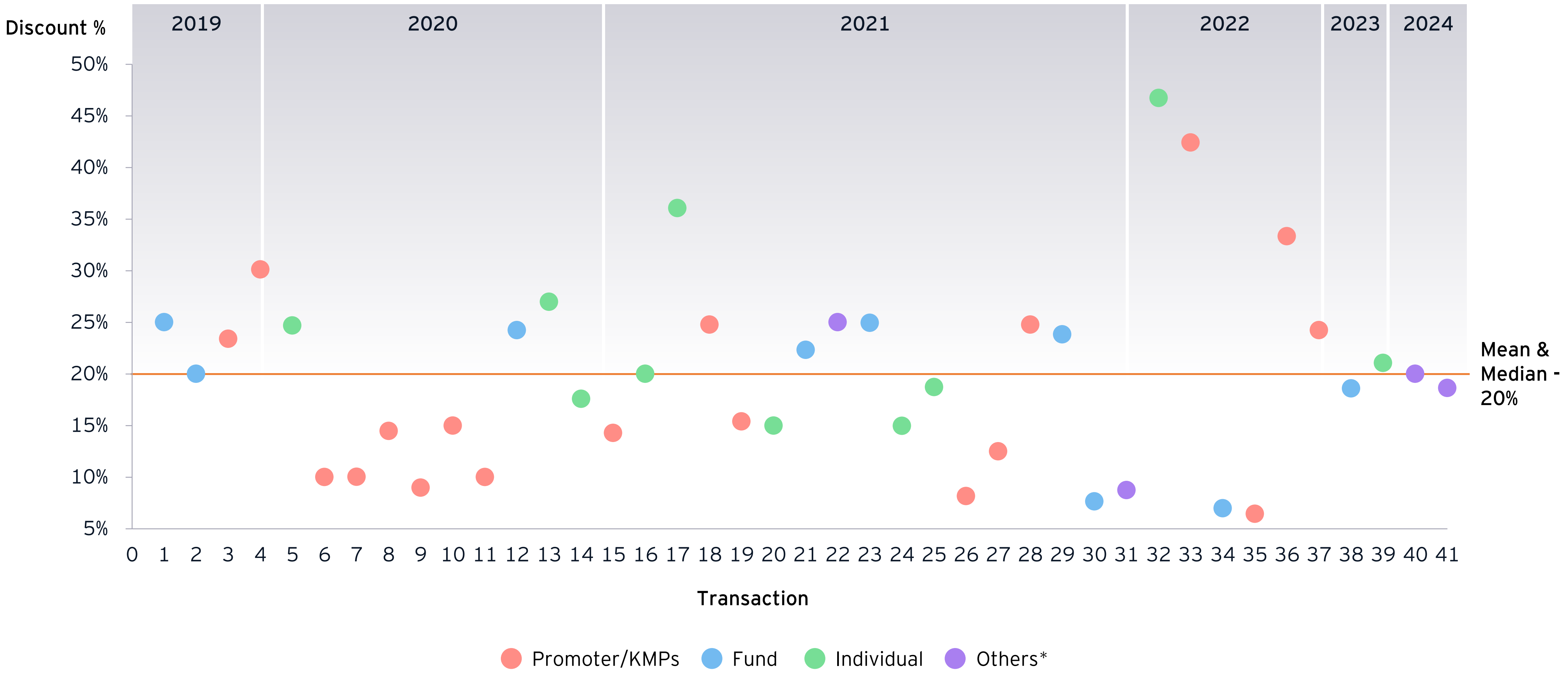
Pro-rata LP

Pro-rata LP rather than LPs with seniority, therefore reducing volatility and perhaps making LP rights immaterial

Negotiation dynamics

Investors with lower LPs may still have better negotiation position in liquidation event

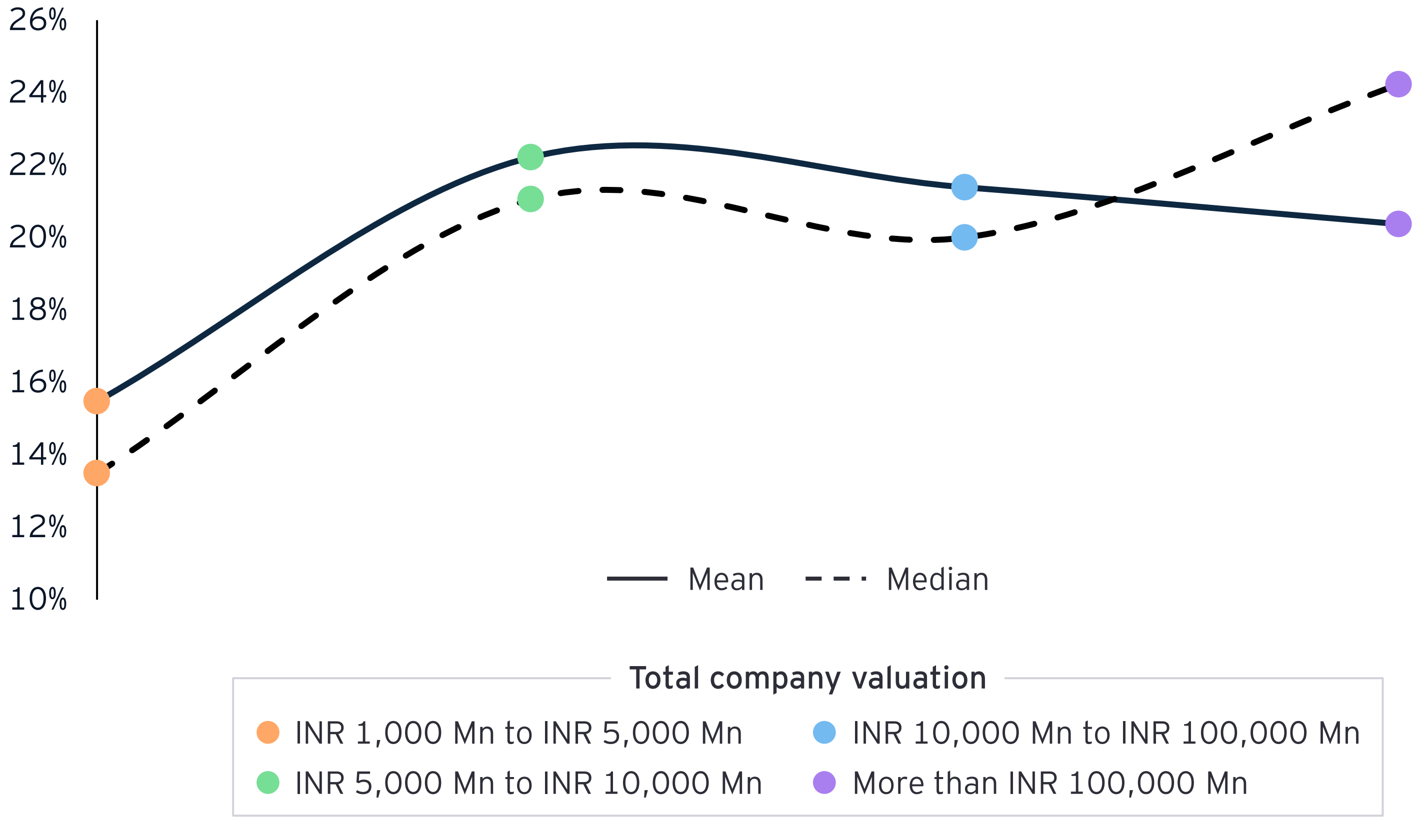
Discounts had reduced during COVID years: mean discount of 18% during 2020 and 2021 vis-à-vis 24% in other years



*Others include deals where the seller consists of corporate investors and deals where the details of the sellers were not available
Source: Private Circle, EY Analysis

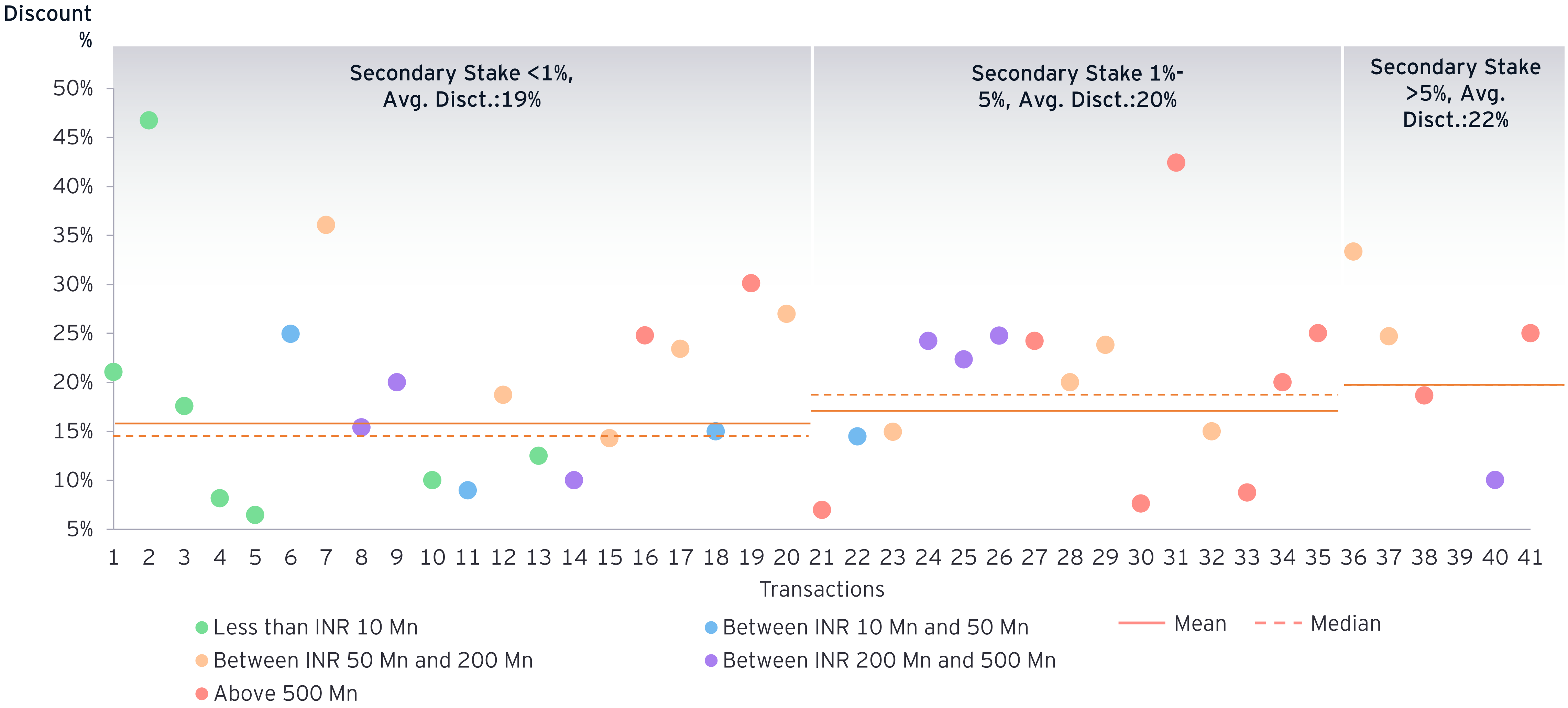
Discount witnessed across all valuation sizes of the companies; albeit lower for smaller companies

The average discount is lower for smaller companies, likely due to the higher probability of binary outcomes



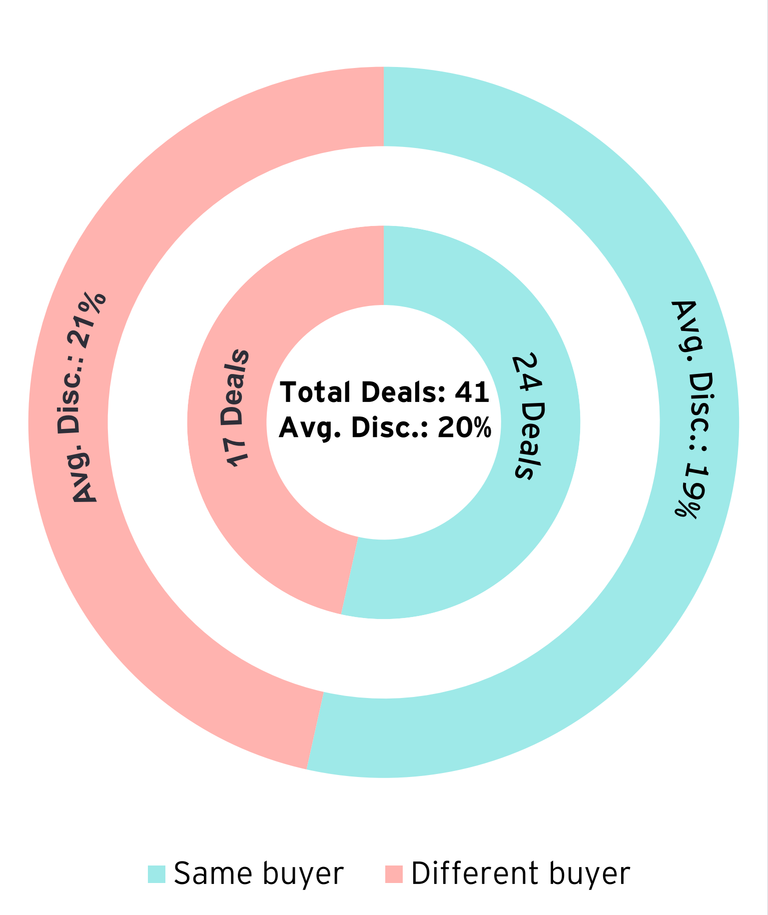
Source: Private Circle, EY Analysis

Discounts did not vary on the basis of percentage stake transacted or the size of transaction



Source: Private Circle, EY Analysis

Profile of buyer (same vis-à-vis different) did not materially impact the discount



Transactions involving at least one common investor in both primary and secondary deals, were more in number than those with different buyers.

Discount was only 1% lower in case of existence of a common buyer vs different buyers in primary and secondary transactions.

*Note: Same investors refers to at least one investor who participated in both Primary and Secondary transactions
Source: Private Circle, EY Analysis

Ernst & Young LLP

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EYG member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP is one of the Indian client serving member firms of EYGM Limited. For more information about our organization, please visit www.ey.com/en_in.

Ernst & Young LLP is a Limited Liability Partnership, registered under the Limited Liability Partnership Act, 2008 in India, having its registered office at Ground Floor, Plot No. 67, Institutional Area, Sector - 44, Gurugram - 122 003, Haryana, India.

EYIN2409-024
ED None

ey.com/en_in

@EY_India | EY | EY India | EY Careers India | @ey_indiacareers

Contact Us

Navin Vohra
Partner
Direct: : +91 22 6192 0930
E-Mail: navin.vohra@in.ey.com

Parag Mehta
Partner
Direct: +91 22 619 21335
E-Mail: parag.mehta@in.ey.com

Amish Mehta
Partner
Direct: +91 22 619 20217
E-Mail: amish.mehta@in.ey.com

Nilesh Jain
Partner
Direct: +91 22 619 21259
E-Mail: jain.nilesh@in.ey.com

Mihir Kenia
Partner
Direct: +91 22 619 21137
E-Mail: mihir.kenia@in.ey.com

Pradeep Gupta
Partner
Direct: +91 124 464 4693
E-Mail: pradeep.gupta@in.ey.com

Venu Yadav
Associate Partner
Direct: +91 22 619 22126
E-Mail: venu.yadav@in.ey.com

Contributors

Hardik Shah
Director
hardik.s.shah@ey.com

Mohammed Fawas
Senior
mohammed.fawas@ey.com

Aditya Kanal
Intern
aditya.kanal@ey.com

Venkateswarlu T
Vice President
venkateswarlu.t@ey.com

Shraddha Singhi
Senior
shraddha.singhi@ey.com

Click here for EY Valuation web page

Disclaimer: The information compiled in this study is based on EY subscribed databases, publicly available information and our analysis. We do not authorise anyone to rely on this study for their specific purposes or to file with regulatory authorities in support of their decisions. Readers should undertake their own necessary analysis of their transaction-specific situation and each comparable transaction independently. The study is intended for informational purposes only and should not be considered as a substitute for professional advice or due diligence.