JAHANI & ASSOCIATES

Thought Leadership

Primary and Secondary Valuation Differences Destroy Investor Returns

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All investors seek a return on capital. This return on capital can come from selling shares through M&A, secondary public transactions, or receiving dividends. When primary and secondary valuations grow far apart, it can destroy investor returns. This destruction is manifested in three distinct problems: companies fail to raise more money, shareholders cannot exit through M&A, and investors must wait extended periods of time to receive a return on their investment.

Companies face problems when the primary valuation at which money is raised deviates from the valuation of M&A or secondary transaction comparables. This is referred to as "the bid-ask spread." The bid is the price the buyer is willing to transact at; the ask is the price the seller is willing to transact at. This terminology is commonly used in public equity market analysis. This article focuses on companies that generate returns through M&A or secondary public transactions.

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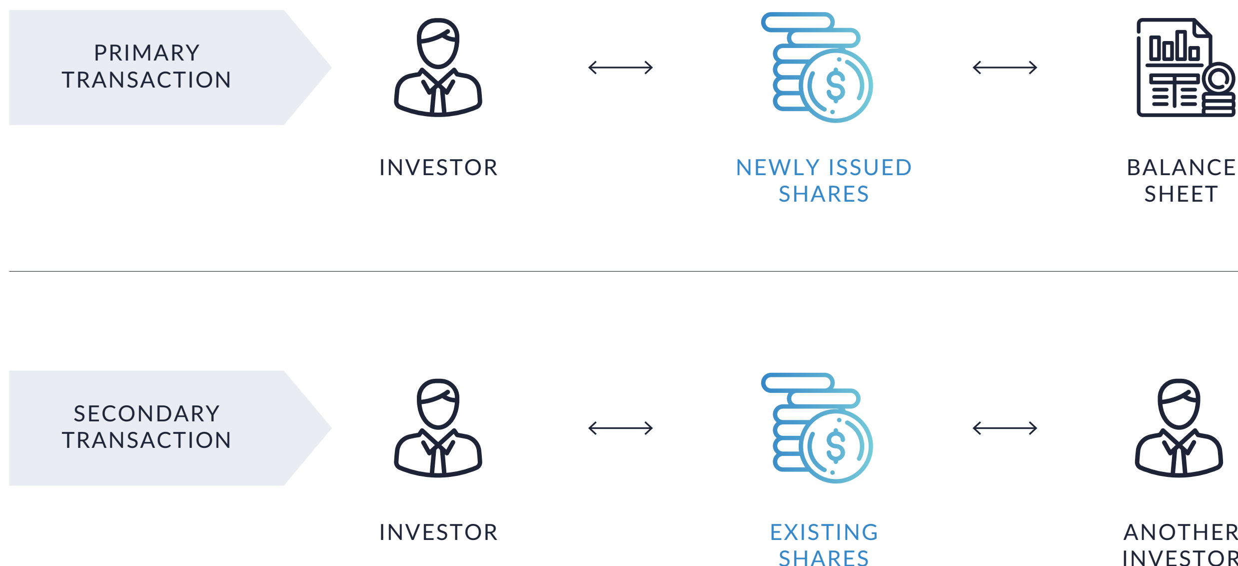
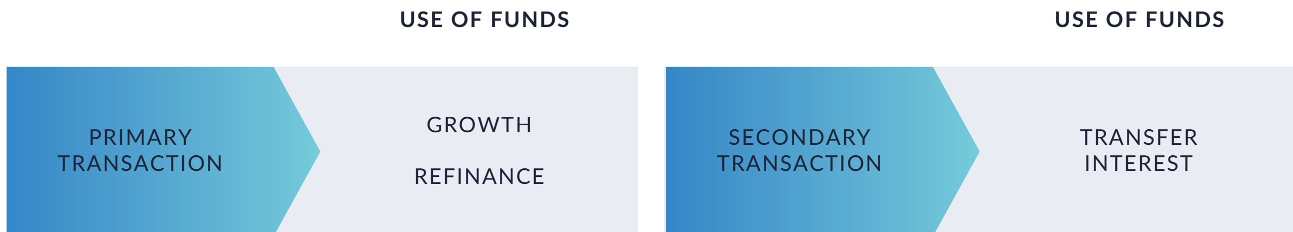
Primary and Secondary Transactions



Primary transactions refer to direct investments an external investor makes into a company in exchange for newly issued shares. This investor is the first owner of the shares, hence the term "primary." This also applies to the initial sale of financial securities such as stocks or bonds through an initial public offering (IPO). In both cases, the proceeds from the sale go directly to the issuing entity. Most companies that seek primary investments are growing and may not yet be profitable. Dividends are uncommon in this sort of company as any profits are generally reinvested back into the growth of the company in the early stages, making it unlikely that primary investors are seeking a return through dividends.

Secondary transactions refer to the buying and selling of existing shares between investors or shareholders. These buyers acquire previously owned shares and are the second or third owners, hence the term, "secondary." In a secondary transaction, the proceeds from the sale go to the previous shareholder directly, and not to the company.

Motivations for Buyers and Sellers in Primary Transactions

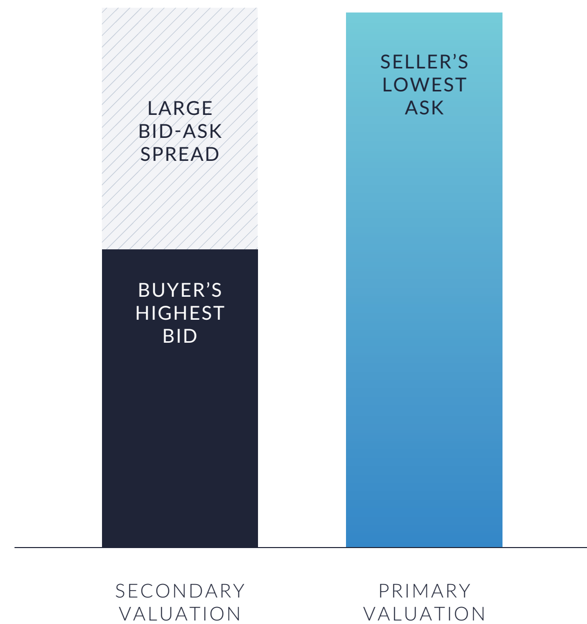


In a primary transaction, the buyers or investors seek returns through capital appreciation. Capital appreciation happens when the company performs well and its value increases, thus, the value of the shares also increases. The investor can then sell these shares for more than they paid, creating a return. Dividends are payments made by a company to its shareholders to distribute profit depending on the number of shares they own. Both payments are in the form of ROI (return on investment) to the shareholder. Capital appreciation is the most common ROI vehicle for high-growth companies.

The sellers, or the companies selling the shares, are motivated to engage in primary transactions to raise money to spend on functions such as: research and development, expanding operations, acquisitions, sales and marketing, global expansion, or paying off debt. Sellers assume these activities will increase corporate value, creating a return through capital appreciation.

Motivations for Buyers and Sellers in Secondary Transactions

Secondary buyer motivations are similar to primary buyer motivations. Buyers believe the monetary gain through appreciation or dividends will be greater than the money paid for the shares. The use of funds between primary and secondary transactions differs greatly. Sellers in secondary transactions are motivated to receive the proceeds through liquidity. When existing shareholders sell their shares, they can obtain cash for other personal or investment purposes. Early investors, founders, or employees who hold equity in a company may seek an exit strategy to monetize their investment or realize gains. Market conditions and a company's performance also play a vital role in this analysis, which influences investors' decision to sell some or all their shares. **It is very important to note that all shareholders must engage in a secondary transaction to receive an ROI.** Primary transactions do not provide ROIs in the form of dividends or appreciation to shareholders.



PROBLEMS WHEN PRIMARY VALUATIONS ECLIPSE SECONDARY VALUATIONS

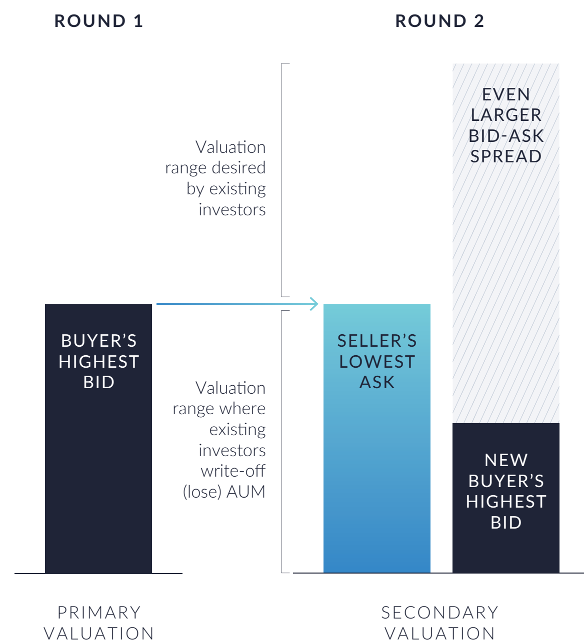
Problem 1: The Company Fails to Raise More Primary Capital

It is important to note that primary investments assume a secondary transaction will happen eventually. In the absence of a secondary transaction that pays the investor more money than the investor originally paid, the only way for the primary investor to get their money back is through dividends.

There is a point where the size of the bid-ask spread becomes insurmountable for any reasonable investor to buy shares. How large of a bid-ask spread is insurmountable? It is not always clear.

A range of 200%, or two times the price paid in a primary round and the current market rate for a secondary round, can be too large to achieve a transaction. Primary round investors seek a price per share higher than they paid, which informs the expectations for future investors and can even widen the bid-ask spread. The investors' role in the bid or the ask changes between rounds. A buyer, or bidder, in round one becomes the potential seller, or asker, in round two.

The most challenging part about this moment, when the bid-ask chasm becomes too high, is that the company's position in capital markets becomes frozen. The company can no longer raise equity to grow. These once high-growth,



exciting companies begin to turn into slow-growth companies, which can impact their secondary valuation even more (slow-growth companies are valued at lower multiples than high-growth companies).

Again, the company itself may not have any meaningful problems. It is simply stuck, locked out of capital markets because the most recent share price cannot be rationalized based on current secondary market comps. And, as discussed, all companies need a secondary exit eventually; without it, investors will not receive a return on capital.

PROBLEMS WHEN PRIMARY VALUATIONS ECLIPSE SECONDARY VALUATIONS

Problem 2: Shareholders Cannot Exit through M&A

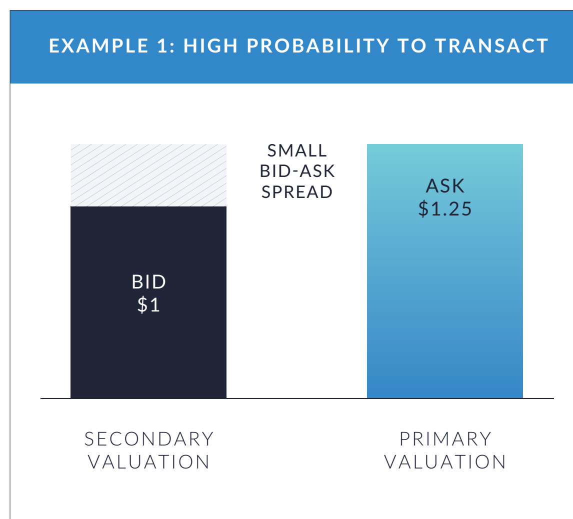
When the primary valuation (the ask) is considerably higher than the secondary valuation (the bid), investors might have overvalued the company based on optimistic assumptions about its growth potential and future performance.

Once these investors try to sell their shares at the price reflecting the primary valuation, they may encounter difficulties, finding buyers unwilling to meet their price expectations. This creates a situation where investors' capital becomes trapped.

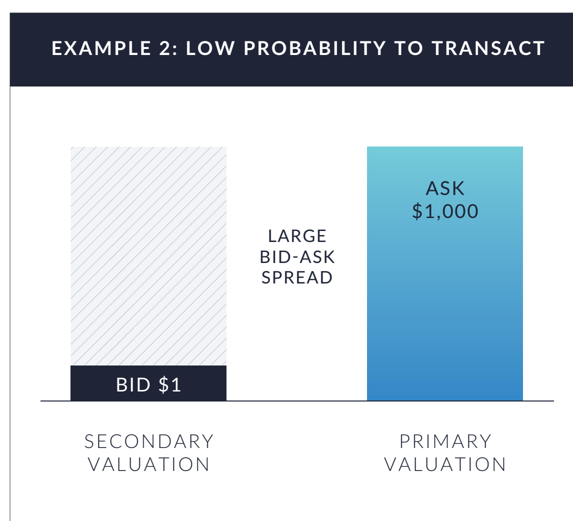
If an investor from a primary transaction pays $1 per share for a company based on its strategy and product market fit, will it sell those shares for less than $1? This rhetorical question points to the bid-ask divide that can eliminate M&A or secondary transactions as an exit option for shareholders. If the investor engages in this transaction, they will lose money.

When confronted with this anecdotal example, investors must consider the benefits of holding onto the shares, hoping the bids from other buyers rise above $1 (the original price paid by the investor), or cutting their losses and selling the shares for less than they paid. An investor's decision between these paths is complex and out of the scope of this report.

There may not be any problems with the company. The company may be growing, have satisfied customers, strong employee relationships, and a pathway toward profitability.



The company simply has not reached the growth target that was the basis for a primary valuation. If this bid-ask spread is too great, it simply eliminates M&A as an exit option. This is bad for shareholders and existing investors. It means new investors are less likely to be interested in the offering, as described in the next section.



PROBLEMS WHEN PRIMARY VALUATIONS ECLIPSE SECONDARY VALUATIONS

Problem 3: Investor Time to ROI Delayed Significantly

Companies have such disparate primary and secondary valuations because the reasons the investors paid the primary share price are not always part of the secondary buyer's decision making. This is almost always due to financial KPIs, such as revenue, EBITDA, gross margin, customer retention, etc.

Companies with large bid-ask spreads must wait months or years for the financial KPIs used in the secondary transactions to match the valuation paid by the primary investor. These long-time horizons are not ideal for most investors.

Financial KPIs matter less in IP-heavy and easily IP-protected business models like biotech. This is the exception rather than the rule.

Valuation increase is driven by a combination of tangible and intangible asset growth, financial performance, financial growth, financial ratios, gross margin improvements, operating efficiencies, scalability, growth potential, customer base retention, potential cash generation, competition, new technology, industry trends, and sentiment.

Valuing a business during a primary transaction is a delicate art, not an exact science. Decision makers need to be careful they do not buy into overly optimistic narratives and pay a price per share that reflects everything going 100% right, 100% of the time. At the same time, undervaluing a business can destroy existing shareholder value. It is Jahani and Associates' experience that most companies suffer from overvaluing their business, raising millions or tens of millions of dollars, and then getting locked out of the capital markets.