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WEALTH MANAGEMENT

PRIMER

Global Investment Office | February 13, 2025

Pre-IPO Liquidity

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In recent years, companies have stayed private longer than ever. Indeed, in 1989, companies going public, on average, were just six years old. By 2021, the average pre-initial public offering (IPO) timeframe had lengthened to 12 years.[1] In addition, at some private companies, management teams have opted to not go public due to regulatory and operational burdens. This delay—if an exit occurs at all—has significant financial implications for employees of startups, as the majority of their compensation typically comes in the form of company stock.

As such, private company executives' desire for pre-IPO liquidity has become increasingly important.[2] Some early employees may have achieved sizable net worth on paper but have limited ready liquidity, which can impede their ability to exercise their stock options or to make a down payment on a home. Moreover, these individuals do not have adequate diversification, as both their income (through their employment) and net worth (through their equity holdings) face material idiosyncratic risk.

A slow IPO market in recent years has prolonged the wait. In the Americas, IPO proceeds clocked in at $7.7 billion in 2022 and $19.4 billion in 2023, compared to an average of $61.4 billion in the 2016-2021 time period.[3] The Americas IPO market fared better in 2024 than 2023, while many industry participants have determined that it remains on track for strong performance in 2025.[4] Still, we believe that the trend of staying private longer may only partially reverse, with pre-IPO liquidity remaining relevant for private company executives.

Fortunately, the options for pre-IPO liquidity have expanded in recent years. We offer several approaches that private company executives may consider, bucketing them into three broad categories: secondary market transactions, lending and outside financing companies (see Exhibit 1 below).

Exhibit 1: Potential Strategies To Consider

Potential Strategy	Description and Considerations
Structured Liquidity Events	Typically organized by private companies on behalf of existing shareholders, allow multiple sellers to liquidate shares at a predetermined price, and include tenders and auctions
Secondary-Transaction Execution Providers	Offer pre-IPO liquidity by allowing existing holders to sell shares to other investors, apart from any structured liquidity event
Loans From Banks	Also called share-pledging, offer private company executives liquidity in certain circumstances by posting shares in company stock as loan collateral, which may carry material risks
Loans From Issuers	Facilitated through issuers themselves, afford employees the opportunity to exercise their options through signing a note payable
Outside Financing Companies	Involve receiving funds to cover the upfront expenses associated with exercising options or liquidity against outright shares in exchange for a fee and the delivery of collateral shares at the time of the prospective liquidity event

Source: Morgan Stanley Wealth Management Global Investment Office (GIO)

Secondary Market Transactions

Structured Liquidity Events

Company management can organize two types of structured liquidity events for employees to gain liquidity while the company is still private: tender offers and auctions. Tender offers are structured liquidity events that allow a set of eligible shareholders to sell shares at a predetermined price. Auctions, on the other hand, pivot on the variables of price and demand to determine the price of shares sold and volume in a secondary transaction. Tender offers are the more dominant structure,[5] leading us to focus our comments there.

Companies may structure tender offers as either a share buyback, in which the company buys the shares back from eligible shareholders, or as an investor-led tender offer, in which investors purchase shares directly from existing shareholders. In both cases, companies or investors will set the share price prior to the offering window. Companies may employ restrictions on both who can participate in any tender offer and how many shares may be sold. Typically, restrictions pertaining to the following may be included: percent of vested equity (often capped at 20%), tenure of employee and whether former employees/consultants/investors can participate.

From an employee perspective, a tender offer provides liquidity while the company is still private versus having to wait for a potential exit. Potential disadvantages include missing out on possible appreciation in those shares and possible forfeiture of favorable tax treatment if shareholders do not satisfy certain holding requirements.

Secondary-Transaction Execution Providers

Secondary-transaction execution providers may also offer liquidity before an IPO or exit by facilitating the sale of existing shareholders' positions to an investor. Existing shareholders could include other investors, companies and employees or other individuals.

Secondary-transaction execution providers leverage the forces of supply and demand and help connect those who wish to sell their shares with a party interested in buying them. Secondary-transaction execution providers may impose certain requirements, including minimum transaction levels.

As with tender offers, secondary-transaction liquidity providers offer upfront liquidity ahead of a potential IPO or exit. Among disadvantages, sellers may face discounts (typically 20% of the estimated fair market value) and may miss out on potential upside. These transactions typically require approval from the company and could conflict with any right-of-first-refusal (ROFR) clauses. These clauses generally give issuers the right to block the transaction or to buy back their own shares first—before any potential secondary market transaction. As such, potential sellers may need to coordinate with company management prior to any secondary market transaction.

Lending

Loans From Banks

While entailing material risk, private share lending may offer liquidity to private company executives and eligible employees in certain circumstances. Also known as share pledging, private share lending involves posting shares of company stock as loan collateral. The employee may then deploy these proceeds to address any spending needs or to invest in diversifying assets. As a downside, this strategy involves leverage and increases portfolio-level risk. Should the pledged stock's valuation drop considerably, the employee could face a margin call, in which case she would be required to either sell shares, pledge additional shares or deliver sufficient cash to satisfy any margin balance or reduce the loan size. Forced sales could prove especially problematic for private company employees, where the shares may have extremely limited marketability.

In addition, acquiring a stock-based loan may prove difficult for private company executives. Banks prefer public equity as collateral, and while some banks may lend against private company shares, loan approvals will come on a case-by-case basis. Indeed, banks tend to be extremely selective regarding the private companies for which they will accept shares as collateral. In addition, banks will likely only accept unrestricted shares, meaning that much of the compensation an executive receives, such as restricted stock units (RSUs) or employee stock options, may not serve as collateral. In sum, this strategy may be most feasible for those with unrestricted shares from late-stage unicorns—particularly for those comfortable with accepting the inherent risks.

Loans From Issuers

While relatively uncommon, companies sometimes loan employees funds to exercise their options. In these cases, employees execute a note payable, promising to repay the company at a specified future time, with interest, for the upfront proceeds received to exercise the option. This strategy carries an important caveat: The long-term capital gains holding period only begins when an investor purchases any shares. If an investor uses a loan to purchase those shares, the IRS only considers the purchase to be valid if the borrower has a personal liability to pay all or a substantial portion of the loan. Therefore, nonrecourse loans do not "start the clock" for capital gains; instead, the borrower must be personally liable for at least a substantial portion of the loan to have the desired effect.[6] This strategy also carries a material level of inherent financial risk: Should the IPO not happen, or the startup fail, the employee's shares may decline to zero value, yet the employee would still be required to satisfy the loan obligation. In sum, a company loan may be feasible for some employees with exercisable options, but employees should weigh the risk-reward tradeoffs before pursuing this strategy.

Outside Financing Companies

Some financing companies offer solutions for those interested in "starting the clock" on their employee stock options or for those looking to pledge their outright shares as collateral.

Financing companies can offer upfront liquidity to exercise stock options, including both to cover the strike price and any taxes due upon exercise. These financing solutions are typically nonrecourse, meaning that the borrower is only responsible for satisfying the loan after the company goes public or is acquired. Some providers offer a form of share lending, including cash advances.

Working with a financing company offers the advantage of permitting employees to exercise their options without surrendering their upside potential, allowing for preferential tax treatment. Exhibit 2 walks through a hypothetical example of working with a liquidity provider. In this example, the hypothetical employee has 1,000,000 nonqualified stock options, all with a strike price of $2. The 409A price and secondary sale price are both $50, and the analysis assumes an eventual sale price of $200. More details can be found in Exhibit 3 in the Appendix.

Among their disadvantages, these strategies may require giving up some company equity; moreover, they require material stock price appreciation and become less compelling as the loan period lengthens. Financing companies typically charge a blended annual percentage rate (APR) of 15%-20%, depending on the rate environment, issuer and borrower.

Exhibit 2: Liquidity Provider Option Approach Versus "Sell To Exercise" and "Exercise and Sell"

	Liquidity Provider	Sell To Exercise	Hold, Then Exercise and Sell
Quantity of Shares	1,000,000	1,000,000	1,000,000
Shares Relinquished	69,981	499,867	
Remaining Shares	930,019	500,133	1,000,000
Gross Proceeds/Intrinsic Value	$186,003,733	$100,026,667	$198,000,000
Total Taxes and Fees (less offset)	-$73,315,863	-$24,471,524	-$90,723,600
Net Proceeds	**$112,687,870**	**$75,555,143**	**$107,276,400**

Note: Tax rates used assume a New York tax resident individual subject to the highest marginal tax rates. This analysis assumes that the financing is treated as an "open transaction" for US federal income tax purposes. Alternate tax characterization may apply depending on the terms of the deal. Consult your tax advisor. Economic terms of liquidity provider deals may vary. This analysis assumes fractional shares can be sold.
Source: Morgan Stanley Wealth Management GIO

Conclusion

With companies staying private longer than at anytime in several decades, the options for pre-IPO liquidity have expanded. Each strategy has its own advantages and disadvantages to consider, and the best path forward will be unique to each individual. To discuss further, please reach out to your Morgan Stanley Financial Advisor.

Appendix

Exhibit 3: Additional Details for Different Strategies

	Liquidity Provider	Sell To Exercise	Hold, Then Exercise and Sell
Quantity of Shares	1,000,000	1,000,000	1,000,000
Shares Relinquished	69,981	499,867	
Gross Proceeds (immediate)	$24,993,333	$24,993,333	
Taxes on Sold Options	$0	-$10,993,868	
Transaction Fee (4%)	-$999,733	-$999,733	
Proceeds for Exercise Cost	-$2,000,000	-$2,000,000	-$2,000,000
Taxes to Hold Options Long	-$21,993,600	-$10,999,732	
Net Liquidity	$0	$0	$0
Sell Remaining Shares at Exit, Assuming a $200 Price			
Remaining Shares	930,019	500,133	1,000,000
Gross Proceeds (at exit)	$186,003,733	$100,026,667	$200,000,000
Fees	-$6,358,304		
Contract Amount	-$24,993,333		
Potential Taxes Due	-$48,930,000	-$24,471,524	-$90,723,600
Potential Tax Offset	$6,965,774		
Net Proceeds	$112,687,870	$75,555,143	$107,276,400

Note: This analysis assumes an incentive fee of 7%, an accrediting rate of 12% and 24 months to an eventual exit.
Source: Morgan Stanley Wealth Management GIO

Endnotes

[1]Ting, Jonathan and Hans Swildens. "How Big Is the Secondary Market for Venture Capital? An Updated View to a $130B Market." Industry Ventures. July 5, 2022.

[2]"Benefits of Pre-IPO Liquidity for Employees: What to Know." EquityZen. June 30, 2022.

[3]"IPO Proceeds by Year". Renaissance Capital.

[4]Ernst & Young. "2024 IPO Wrapped: Americas and EMEIA Recover, Asia-Pacific Lags," Press Release. December 18, 2024.

[5]"An Introduction to Secondary Auctions for Private Companies." Nasdaq Private Market.

[6]Because the specific structure of the company loan can impact the tax treatment of the loan and the option exercise, consult a tax advisor before entering into a company loan to exercise options.

Disclosure Section

Hypothetical Performance

General: Hypothetical performance should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Hypothetical performance results have inherent limitations. The performance shown here is simulated performance not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results.

Despite the limitations of hypothetical performance, these hypothetical performance results may allow clients and Financial Advisors to obtain a sense of the risk / return trade-off of different asset allocation constructs.

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk or guarantee investment results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis. The return assumptions are based on hypothetical rates of return of securities indices, which serve as proxies for the asset classes. Moreover, different forecasts may choose different indices as a proxy for the same asset class, thus influencing the return of the asset class.

Risk Considerations

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

IPOs Participating in a new issue/syndicate is subject to availability. Initial public offerings (IPOs) are highly speculative and may not be appropriate for all investors because they lack a stock-trading history and usually involve smaller and newer companies that tend to have limited operating histories, less experienced management teams, and fewer products or customers. Also, the offering price of an IPO reflects a negotiated estimate as to the value of the company, which may bear little relationship to the trading price of the securities, and it is not uncommon for the closing price of the shares shortly after the IPO to be well above or below the offering price.

Alternative investments may be either traditional alternative investment vehicles, such as hedge funds, fund of hedge funds, private equity, private real estate and managed futures or, non-traditional products such as mutual funds and exchange-traded funds that also seek alternative-like exposure but have significant differences from traditional alternative investments. The risks of traditional alternative investments may include: can be highly illiquid, speculative and not appropriate for all investors, loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than open-end mutual funds, and risks associated with the operations, personnel and processes of the manager. Non-traditional alternative strategy products may employ various investment strategies and techniques for both hedging and more speculative purposes such as short-selling, leverage, derivatives and options, which can increase volatility and the risk of investment loss. These investments are subject to the risks normally associated with debt instruments and also carry substantial additional risks. Investors could lose all or a substantial amount of their investment. These investments typically have higher fees or expenses than traditional investments.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies.

REITs investing risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

Diversification does not guarantee a profit or protect against a loss in a declining financial market.

Direct indexing may only be appropriate for people who have a considerable amount to invest in a taxable account and want a level of customization they couldn't otherwise obtain through a portfolio of funds or individual securities. If you invest in a tax-deferred account, such as a 401(k) or IRA, the tax-harvesting benefits of direct indexing may provide no additional benefit to you. There is no guarantee that you will maximize value by tax-loss selling; holding onto slumping stock may have resulted in value greater than that obtained through tax-loss harvesting via direct indexing. In addition, you will incur asset-based fees and expenses in a direct indexing account that may be higher than those for other investments, as well as transaction costs arising from customization and frequent rebalancing.

Environmental, Social and Governance ("ESG") investments in a portfolio may experience performance that is lower or higher than a portfolio not employing such practices. Portfolios with ESG restrictions and strategies as well as ESG investments may not be able to take advantage of the same opportunities or market trends as portfolios where ESG criteria is not applied. There are inconsistent ESG definitions and criteria within the industry, as well as multiple ESG ratings providers that provide ESG ratings of the same subject companies and/or securities that vary among the providers. Certain issuers of investments may have differing and inconsistent views concerning ESG criteria where the ESG claims made in offering documents or other literature may overstate ESG impact. ESG designations are as of the date of this material, and no assurance is provided that the underlying assets have maintained or will maintain and such designation or any stated ESG compliance. As a result, it is difficult to compare ESG investment products or to evaluate an ESG investment product in comparison to one that does not focus on ESG. Investors should also independently consider whether the ESG investment product meets their own ESG objectives or criteria. There is no assurance that an ESG investing strategy or techniques employed will be successful. Past performance is not a guarantee or a dependable measure of future results.

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RSI1739383982624 02/2025