

WINNING HAND

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Whilst the LBO players are fretting over the state of the buyouts market and the future of their portfolios, the secondaries specialists are rubbing their hands at the prospects as they look to clean up.

A few years ago, GPs and LPs tended to sup with a long spoon when dealing with specialist players in the secondaries market. The lack of players in the market segment meant they feared they would end up being fleeced if they dealt with them – and so they only tended to do so out of desperation, as there was still a degree of stigma attached.

Today, however, attitudes have changed. Julian Mash, founder and chief executive of Vision Capital, says: “Ten years ago secondary deals were seen as a sign of failure. Now they're approaching half the market – and there is no reason why portfolio sales should not be accepted in the same way.”

Mathieu Drean, managing partner of the specialist agents Triago, says: “Before early 2007 there was a false perception that, by definition, sellers would get creamed and that this was an unattractive part of the market largely inhabited by vulture funds. But I think that changed last year when people became much more relaxed about selling on the secondaries market. The increased number of specialist players in the sector has helped to remove any of the stigma. There is now a collective appreciation that the secondary market can work – and it is no longer seen as somewhere you only go when you are obliged to and where you will invariably get creamed.”

Indeed, the recent emergence of a dynamic, flexible, robust and innovative secondaries market is broadly welcomed within the industry, largely because it boosts the liquidity of an otherwise illiquid asset class.

The strengthening of the market is particularly welcomed by LPs. Not only can they use the market as asset allocation and re-allocation tool, they can also use it to make public their dissatisfaction with underperforming LPs. GPs are probably less fulsome in their support for the market – although many do welcome the fact the more fledgling direct secondaries market enables them to offload portfolios of assets which might otherwise be unsaleable.

Mash says: “The secondary direct market hardly existed at all five years ago. While it is still an emerging market, it is increasingly recognised as a smart exit route. The advantages for the seller include less risk and a faster timetable.”

The credit crunch, however, has had an asymmetric impact. While its effect on highly leveraged buyouts has been almost universally negative, the repercussions for the secondaries market have arguably been much more positive.

This is ironic, given that until quite recently the buyout kings were so sceptical about the secondaries market. They tended to regard it as a “poor relation” of their brand of private equity, somewhere you ventured rarely for fear of getting fleeced. Now, however the balance of power has shifted. Indeed the liquidity crisis appears to be putting wind in the sails of the secondaries players, while leaving many in the buyout space becalmed in the doldrums.

David Williamson, founder and managing director of Nova Capital Management, a direct secondaries investment firm with offices in London and Connecticut, believes it was inevitable that the secondaries market would be less troubled than the buyout market.

“The secondaries market is much more about changing businesses, adding value, and hopefully making them much more attractive businesses to sell,” says Williamson. He believes that with their lesser dependence on leverage and financial engineering, secondaries players have less of an imperative to reconsider their business model in the wake of the crunch.

The credit crunch is helping the secondaries market in a range of other ways, for example because of the structural changes it is forcing on the banking sector. A combination of write-downs on sub-prime-tainted securities together with the more stringent capital requirements under the Basel II capital framework, is forcing banks and other financial institutions to re-examine their balance sheets and seek to deploy their capital in more efficient ways. This is prompting many banks into a sometimes painful jettisoning of their non-core assets – and “cash hungry” private equity holdings have been among the first to go.

Williamson says the credit crunch is sparking scores of “distress sales” across the banking and financial sector, which is providing an unusually rich stamping ground for secondaries buyers including Nova. He says: “The credit crunch has definitely caused deal-flow to accelerate for us, and I’d imagine that’s true right across the secondary market.”

One example came when Royal Bank of Scotland sold a large tranche of private equity assets last December. The bank bundled the assets into a new vehicle, the RBS Special Opportunities Fund, which it then sold to four of the world’s leading secondary and fund of fund houses: London-based Collier Capital, Switzerland-based Partners Group, Amsterdam-based Alpinvest and Boston-based HarbourVest.

Sources close to the £1.1bn deal say the bidders were offered certain “structural enhancements”, including assistance with debt finance, to whet their enthusiasm for the deal. Like other recent and planned disposals by RBS, the deal was designed to shore up the bank’s balance sheet and improve its capital ratios in the wake of its acquisition of ABN AMRO. Many secondaries players now foresee a rash of similar deals from other global banks.

Were all the banks and institutional investors that are currently considering such deals to take the plunge, the secondary market would swell enormously. According to Oak Hill Investment Management partner James Hale, it would grow from about 3% of global private equity commitments to 10% to 12%.

The credit crunch is also fuelling the market for secondary deals in other ways. Williamson, for example, believes that direct secondary deals are easier to pull off when “M&A markets are stickier.” This is because at times like these corporates and other prospective vendors are more likely to agree to sell portfolios of businesses in job lots rather than seek to achieve potentially higher returns by selling them off one by one.

Another ripple effect from the credit crunch has been that it is obliging limited partners such as pension funds find ways of trimming their overall exposure to private equity. This can occur when fears of an economic downturn squeeze the value of other parts of their investment portfolios – such as equities. This has happened to many pension schemes who are turning to the secondaries market to ensure they can adhere to pre-agreed asset allocations.

“The secondary market is increasingly becoming recognised as an asset management tool,” said Tim Jones, a partner in Collier Capital. “That is good news for private equity; one of the

hesitations that investors have about the asset class is can they get out of it if they want to get out of it.”

Pension funds are also embarking on secondary sales as a means of streamlining their relationships with general partners. Last year, the California state pension fund, Calpers, decided it made no sense to have relationships with 140 general partners and chose to cut the number of relationships to 30 or 40. In a complex and sometimes chaotic transaction overseen by UBS, Calpers finally offloaded some US\$3bn of private equity commitments in February.

Buyers included the local asset manager Oak Hill and the Amsterdam-listed fund of funds Conversus Capital. Other buyers included New York-based Lexington Partners, Boston-based HarbourVest and London-based Pantheon Ventures.

The secondaries market is certainly showing little sign of deceleration at the moment. Drean argues it has become one of the liveliest parts of the entire private equity market, largely because the number of potential buyers has mushroomed.

“Unlike six or seven years ago the market is no longer dependent on a small bunch of specialist funds,” says Drean. “It is no longer a cottage industry. On the buy-side half the market is made up of specialist players such as Collier, Lexington and Goldman Sachs. But now buyers of primary assets such as AXA have also become big buyers of secondary assets.” The danger of the late surge in interest is that valuations could sky-rocket however there is little evidence of this so far and it probably has to do with longer holding periods and the negative economic outlook.

Overall, in fact, prices on the secondaries market are said to be falling in Europe – even though there is a greater number of players now fishing in the same pond. Drean says: “Buyers are paying the same as they would have paid a year ago, but the truth is that if you make an index of prices, the average buyer is probably paying less than they did a year ago.” Reasons probably also include that the market became rather “hot” in early to mid-2007.

However Michael Belsley, a partner with Chicago-based law firm Kirkland & Ellis is less confident that bargains can still be had. He says: “The secondary market has matured to the extent sellers have become much more comfortable with it as an exit route, as a mechanism to achieve liquidity. As more and more competitors have entered the market, sponsors have become more comfortable with the process and pricing has narrowed, removing some of the profit that was previously available to buyers.”

Generally, however, prices for secondary assets remain weaker in Europe than they are in the US – partly owing to the relative lack of specialist players active in the market and because many corporates are selling portfolios of non-core assets for strategic reasons and are therefore less obsessed by price.

Collier Capital’s Jones says: “If you’re a seller you’ll probably be looking at a valuation from the past and if you’re a buyer you’ll be looking at what’s happening in the future. This makes it difficult to come to an easy agreement on price.” This is almost certain to mean some planned deals hit the buffers.

He believes that GPs have been marking their books down quite slowly since the credit crunch. He says that the reason prices have deflated more slowly than on the public markets is because books are only marked down twice a year – in June and December. “That gives GP’s opportunity to assess whether the credit crunch is a long-term development or a short-term blip,” says Jones.

In any case Jones believes that, in the current climate, price has become less pre-eminent in negotiations. He believes that “structured solutions” in which banks lend secondary buyers a

large chunk of the money to take certain assets off their balance sheets are becoming much more prevalent. He cites a recent deal in which Apollo Management and TPG bought a £12bn book of leveraged loans from Citi – which in turn lent the buyers US\$9bn of the US\$12bn.

There certainly appears to have been no let-up in limited partner appetite for the sector. Landmark fund raisings in Europe last year included AXA Private Equity's US\$2.9bn AXA Secondary Fund IV and the US\$4.8bn Collier International Partners V. The latter is the world's largest dedicated secondaries fund, is already more than half invested.

According to researchers at Private Equity Intelligence, a total of 11 new secondaries funds were raised in 2007 – pulling in US\$15.2bn between them. So far this year, a further five new secondaries funds have reached final close, raising just under US\$3bn. And a further 17 new secondaries funds are currently on the road, and these targeting a further US\$20bn between them.

Among funds currently seeking investors are a €2bn fund that from the Switzerland-based Partners Group and seven funds from US-based secondaries houses CSFB, HarbourVest, Lehman Brothers, Pomona Capital and Lexington Partners. Each of these players are targeting at least one fund in the US\$1bn to US\$5bn range.

According to Nova's Williamson another area that can be expected to display rapid growth in coming years is corporate transactions – where a corporate decides to sell a job lot of non-core businesses to a specialist secondary buyout fund.

"That's the most interesting part of the market," says Williamson. "Three of the last acquisitions we have made have been from corporate sellers."

One advantage from the buyer's perspective is they usually have to deal with just one party on the other side of the table – which tends to smooth the process as well as making it easier to buy majority or controlling stakes.

Williamson cites the example of a deal last November when Nova bought six businesses from Johannesburg-based Barloworld. Nova paid a total of £75m for Barloworld Scientific Laboratory Group, with HSBC throwing in £40m of senior debt and working capital. The UK-based Scientific Laboratory Group sells lab equipment including Pyrex glassware and Sterilin plasticware into 100 countries. Williamson says that Nova has already separated out the six businesses that were previously run as a group, partly in a bid to improve their performance but also to facilitate eventual exits.

As the market matures, innovation is still occurring. Recent innovations include deals between secondaries houses – a recent one occurred when Collier sold a portfolio of businesses it acquired from Abbey National in 2003 to Vision Capital and so-called "stapled secondaries" in which a vendor will agree to sell a bunch of assets to a secondaries player at a reduced price on condition the latter also commits to a new or replacement fund.

"I think the market is reaching maturity," says Mark Mifsud, a partner in law firm Kirkland & Ellis. "We have reached an inflexion point where there are far more buyers of secondary assets including insurance companies pension plans, endowments, strategic corporate investors and where deals are much more pronounced and where the sellers who say "no" to secondary transactions are in the minority.

"You're going to see this market continue to grow because it allows investors to move further along the j-curve. The growth of the secondaries market also reflects the fact private equity itself has matured into a proper asset class."

Jones says: "I think this market will grow and grow. The size of transactions will continue to grow, as will fund sizes. US\$1bn transactions will no longer be unusual. There will be fairly steady upwards growth in the secondary market and the credit crunch will probably accelerate that growth."

BOX]

Liquid venture

The emerging venture secondaries market is starting gains traction as VCs look to offload investments and free up capital.

Many of the technology investments made in haste by venture capitalists at the peak of the dot.com bubble are now being repented at leisure. Those investee companies that have not gone bust or been sold off in IPOs – roughly one-third of the total – are still clogging up investor portfolios even a decade after they were acquired.

This is clearly something of an embarrassment to some of the general partners concerned, especially since many of their limited partners would now rather deploy their capital in more productive ways. Apax Partners and 3i, for example, have both changed tack since the 1990s in order to focus on larger buyout type deals. Yet both still have scores of underperforming technology and early stage investments on their books, which they are becoming increasingly keen to offload.

Luckily a new breed of specialist venture capital secondaries player has emerged in recent years to help take up the slack – bringing much needed liquidity to an otherwise sclerotic part of the market. Secondaries houses that are already playing an active part in this market segment include Munich-based Cipio Partners, San Francisco-based Saints Capital, Industry Ventures, Lake Street Capital, London-based Pantheon Ventures and Paul Capital. Their ranks have also been swelled by several UK-based start-ups including Azini Capital, Shackleton Ventures and Tempo Capital Partners.

Michael Bennett, founder and partner in Azini Capital, says: "There are masses of technology companies out there which have been through a number of venture capital funding rounds but failed to reach the stars. They may be turning over £5m to £10m and be at or about to reach break even. However some of their shareholders might be out of time, out of money, have changed their strategy or be in need of liquidity."

Based in Kingston-upon-Thames, Azini Capital last September completed its first £30m fund raising with backing from two larger secondaries players – Greenpark Capital and Lexington Partners. Bennett says it is looking to "liberate value in companies that require additional time and fresh capital in order to realise maximum value."

He explains that Azini differs from players like Shackleton in that it prefers to invest on a company-by-company basis rather than taking on patchier job lots of assets. He believes this enables it to focus on quality assets that have strong future prospects and for which market prices are more justified.

In its first deal Azini Capital last September bought a number of shareholdings in growth-stage technology firms from the property company CLS Holdings, as well as a part share of a fund managed by Pond Ventures, the Silicon Valley-based venture capital investor. The CLS deal brought stakes in three Cambridge-based technology companies – Amino Technologies, an Aim-listed maker of set-top boxes, Antenna which makes antennae, and Keronite which makes ultra-

resilient coatings. Meanwhile the Pond Ventures fund owns stakes in Picochip, a Bath-based chip designer and Transitive, a software company that has offices in Manchester and California.

Bennett says: "A lot of money was invested in venture capital in 1998 and 1999 and about 1000 companies were started up. The stellar ones have been sold or IPO-ed long ago. The terrible ones have died. But a lot just limped along and have only recently started to work. However a lot of the investors in these businesses are now looking for liquidity."

In the US the "walking wounded" from the dot.com bubble years are even more pronounced than in the UK. Overall, there are about 210 era-era venture capital firms which have failed to raise any new funds since 2000, according to research by Thomson Financial.

Unsurprisingly, the limited partners in such funds are becoming increasingly eager to withdraw their money. The general partners concerned have another headache. Many took investments from a now-defunct US government programme that was managed by the Small Business Administration. The programme, which was suspended in 2005, provided twice what a venture fund raised from external private sector investors in exchange for its money back plus a small amount of interest and 10% of a fund's returns.

Now, many US venture capital funds are finding they don't have sufficient funds to repay the government its due. "A whole bunch of funds are being motivated by SBA dynamics to sell off a percentage of their ownership," Ken Sawyer, founder of San Francisco-based Saints Capital, has said. It's the sort of thing some venture secondaries players plainly relish.

In the UK 3i sold a collection of technology and early stage businesses to Saints Capital in September 2006. It then sold a further batch of 13 businesses to Shackleton Ventures in April 2008. Shackleton's managing partner Hugh Stewart is confident these sorts of deals are going to become more prevalent in the Old Continent. He says: "The market for venture secondaries is still relatively young but, we believe, is set to grow as secondaries transactions become a standard part of portfolio management in Europe."