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Unlock the value

By Mathieu Dréan of Triago

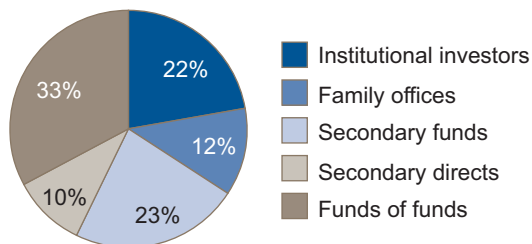
Most comments in last year's *Guide to the Secondary Market* seemed to focus on the new "secondary boom," and on how the secondary market was evolving into a mature forum where buyers and sellers can transact more routinely, without much fear of opprobrium.

Behind an undisputable increase in activity is more than the effect of the current economic downturn. A profound change has happened. The industry has progressively crossed a number of major hurdles of the past years, and it looks like a new liquidity paradigm has developed in private equity. The market has not only grown and matured, but initial negative perceptions have begun to dissipate as all players in the industry experience and realize the simple merits of a secondary sale or acquisition. The landscape has been truly transformed and attitudes have greatly evolved.

Changes among secondary buyers

Secondary fund-raising has boomed in recent years, as more limited partners have realized the merits of buying into funds on the secondary market. Aside from the obvious benefits of mitigating the J-curve that secondary funds provide, more investors are seeking relationships with new managers through secondary opportunities.

Secondary buyers by type



At the same time, the secondary market is no longer exclusively the playground of specialized funds, as the expansion of the market has brought in new types of buyers. Over the past 15 years, Triago has developed a broad base of private equity investors worldwide that currently totals over 150 buyers with different investment focuses, tastes and capabilities.

Taking into account undeployed capital from dedicated secondary funds and the available capital for secondary purchases from non-dedicated buyers, we estimate that over \$25 billion is currently available for secondary purchases. Investors with different needs and capital structures than traditional secondary funds have at times proved quite competitive as they seek to carry out portfolio diversification, manage the J-curve or establish relationships with closed funds.

Active portfolio management

Simultaneous with the increase in capital available for secondary opportunities, there has been a boost in deal flow,

as sellers' goals have changed. Today, a majority of institutional and private investors access the secondary market to actively manage their private equity portfolios, in contrast to the past, when the market was primarily the province of more strategic, structural or so-called distressed sellers.

It takes the average private equity fund 3.69 years to invest 80% or more of its capital and seven years to return all committed capital and begin generating positive returns, according to research from A. Ljungqvist and M. Richardson of New York University's Stern School of Business. During that time, many things can change, from either the general partner's or limited partner's perspective.

Investors may need to accelerate the monetization of selected assets, crystallize cash-on-cash value, lock in performance, carry out arbitrage, concentrate on a smaller number of core GP relationships, optimize the structure and overall profile of their portfolios or reduce future commitments outstanding. Many of them now realize that a newly dynamic secondary market can serve their needs in this regard.

As the dispersion of returns among fund managers rises, investors are likely to place an even greater premium on genuinely differentiated investment strategies, and thus seek out the secondary market even more to make adjustments to their portfolios.

In the past, general partners were skeptical about secondary sales. But as volume has increased, most general partners have by now integrated the term "secondaries" into their vocabulary. Getting a call from a limited partner considering the sale of its position is no longer a surprise or a shock for general partners; they have become quite used to dealing with transfer documentation.

Although they remain sensitive to how such transfers are executed, most general partners acknowledge that secondary transactions offer a chance to build quality new relationships. Rather than deal with a limited partner who does not expect to participate in future fund-raising, they welcome the chance to add a new investor interested in contributing to future funds.

Indeed, even general partners who manage secondary funds themselves have begun participating in the market as sellers on occasion, applying the same rationale as other sellers to improve their cash-on-cash performance and manage their own portfolios. The distinction between strictly buying and strictly selling is dissipating, and the time has come for investors on both sides of the Atlantic to acknowledge that the active management of private equity portfolios can be a viable option that pays dividends.

The mark-to-market conundrum

The implementation of a new accounting rule, FASB 157, will start changing how secondary transactions are valued. While some worry that this new accounting rule could bring secondary dealmaking to a halt, our market experience leads us to believe that the current evolution in valuation guidelines

towards more mark-to-market-based approaches should create a more favorable environment for secondary transactions.

FASB 157 discusses the use of fair value in financial statements. In relationship to private equity firms, it requires that they value their portfolio investments at current market value when they report their financials, rather than holding investments at cost, as many firms did previously. FASB 157 was not specifically created for private equity and will increase the focus on the fair value issue in private equity.

Fair value doesn't only affect general partners. Since fair value reporting is a GAAP requirement, limited partners are being held accountable for the values that their general partners report to them. Without clear fair value information from their general partners, limited partners would find it difficult to come up with fair value determinations in their own financial statements.

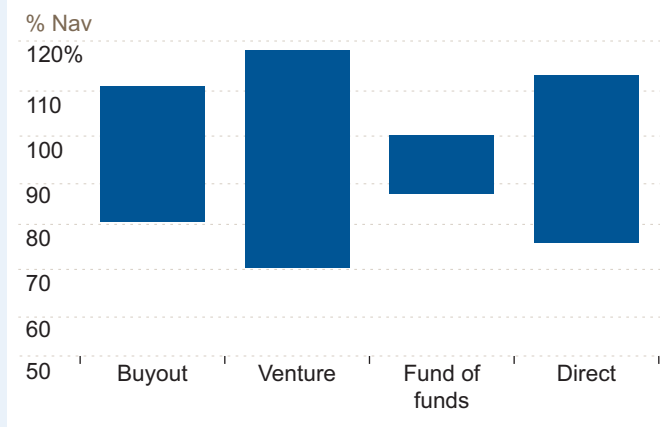
As general and limited partners mark the values of their portfolios up or down more frequently, the reported net asset value of those portfolios will be much closer to the likely actual value of the portfolio than it was previously. That is likely to narrow the pricing spreads in secondary transactions, making it harder to sell stakes for a premium to NAV. For that reason, most buyers don't necessarily see FASB 157 as good news.

But ultimately, the new rule should increase transparency for all parties involved in a secondary transaction. Often, the fact that investors didn't necessarily feel they had good insight into what their funds were actually worth made them less likely to pursue secondary arbitrage or entertain prices offered. If all parties are more comfortable that they understand the underlying value of a portfolio, that can only increase their comfort with doing a secondary deal. That in turn could translate into many more transaction opportunities involving single fund interests or small portfolios.

Pricing changes

The flood of capital into secondary funds and the entrance of non-specialized buyers of secondaries, combined with an increase in intermediary-led competitive processes, has eliminated the deep discounts that were common in the early days of the market. Many of today's secondary buyers follow a model of "fair pricing" rather than automatic discounts.

Average secondary bid spreads



Buyer Selection: Key Criteria

Buyer Specific Appetite: Does the interest or portfolio of interests fit with the potential buyer's appetite in terms of strategy, geography, maturity and size?

Buyer General Appetite: competitiveness, return expectations, cost of capital...

Buyer Capabilities: Does the potential buyer have the technical (team resources, knowledge and sophistication, tax and legal restrictions...) and financial capabilities to execute the deal?

Buyer Reputation: Can the buyer be trusted on confidentiality and the ability to execute the deal?

Buyer Network: Does the buyer work in cooperation with other buyers also included in the transaction? Are there possible conflicts of interests or collusion risks?

Buyer Profile: Is the GP likely to welcome such new relationship and cooperate in the process? Is the buyer acceptable to the GP for consent? Does the buyer comply with "Know Your Customer" rules?

But after the credit markets seized up in the second half of last year, we have seen spreads in bids widen in recent months. Many buyers believe prices have come down significantly, citing the likelihood that buyout funds' returns in particular seem less likely to be as good as they have been in the last few years.

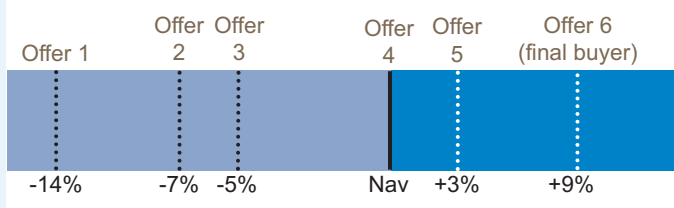
But have prices really come down as much as buyers say they have? Certainly, the average price offered by a less enthusiastic buyer is less attractive than it was a year ago. But the average does not really matter. It is the most competitive, highest offer that typically wins a bidding process, and our experience in transactions we have handled in the last six months is that for any given deal, the high bid is generally coming in strong and relatively in line with prices seen a year ago.

Similarly, the NAVs reported by funds haven't tended to come down, even as broader market indices have declined, in part because fund managers were generally prudent in not marking their holdings up in the first part of 2007. But as the economic

Offers on a top US venture fund raised in 2000



Offers on a top US buyout fund raised in 2005



environment impacts fund managers' ability to exit their investments, the returns prospects for their assets will be impacted by likely longer holding periods before value can be realized, ultimately lowering their NAVs.

What the pricing data observed from actual transactions conducted by Triago do make clear is that pricing spreads in the secondary market are wide, as highlighted in the previous charts. On a single asset at a single point in time, in most cases the variance in bids exceed 2,500 basis points (where bids are expressed as a percent of NAV). Therefore, the indication received from one buyer for an interest may not be indicative of the optimal price which could be obtained.

Some participants in the secondary market say that volume in the market has declined as buyers bids come down. But aside from a few recent situations in the U.S. where vendors' price expectations weren't carefully managed, we at Triago have not experienced any hiatus in transaction activity thus far. As long as the right bidders are involved, there is every reason to expect to be able to transact at a fair price. That being said, in such turbulent and erratic markets, it's even more important not to rely on average prices from average buyers.

Prior to pursuing any transaction, team members from Triago conduct in-depth preliminary analyses of a potential seller's portfolio to provide insights on appropriate liquidity solutions and valuation estimates, with the goal of determining the feasibility of the transaction given the objectives of the investor. Triago's mandate is to act as an agent exclusively to sellers.

The value of a specialized adviser

Interestingly, increased liquidity hasn't translated into increased efficiency. With all these changes, the secondary market for private equity interests remains at least as inefficient as it has always been. This is one of the main reasons why many potential sellers see the benefits in approaching the market with the assistance of a specialized adviser that can provide A-to-Z guidance throughout the transaction process.

To optimize the chances of success in a transaction, it's essential to be able to plug into the flow of the secondary market alongside specialists with unique exposure to reference points on prices, and with immediate access to the most suitable selection of potential buyers. Discretion, confidentiality and proper coordination are key principles not only to executing a transaction smoothly, but also to making sure that general partners are comfortable with the process.

Buyers themselves have come to appreciate the involvement of a good adviser. Beyond viewing Triago as a source for qualified deal flow, buyers appreciate our presence as a catalyst, properly coordinating all aspects of a transaction, with the sole objective to get the deal done in satisfying terms to all.



Mathieu Dréan has been in charge of the operations of Triago-X, Triago Group's unit specializing in secondary transactions, since its creation. Before joining Triago in 1998, Mathieu was a sales manager in a trading company.