MERGERS & ACQUISITIONS

An Overlooked Outlet

December 14, 2009

By Danielle Fugazy

The fate of New York-based hedge fund billionaire Raj Rajaratnam was well publicized as many newspapers ran pictures of Rajaratnam being hauled off to prison in handcuffs.

Although Rajaratnam vowed to fight the charges, which are centered around insider trading allegations, the negative press forced Galleon Group, Rajaratnam's hedge fund, to cease operations and liquidate $3.7 billion worth of assets in short order. Guilty or not, Galleon's investors didn't want to wait around for a verdict, forcing the firm to seek out liquidity wherever it could find it.

Most direct secondary buyers and the firms that sell to them try to keep their business far removed from the spotlight. Many, however, in the trade point to the situation facing Galleon as the ideal scenario for direct secondary investors -- namely a motivated buyer facing a time crunch that doesn't allow for a traditional exit.

"They had to get those assets sold and the direct secondary market is where to do it," says one direct secondary buyer. "If you can't enter the public markets through an IPO or sell in a traditional way, this is the only way out."

Gaining popularity, the direct secondary market has become somewhat of a bailout for private equity firms, hedge funds, VCs and limited partners looking to exit struggling investments, gain liquidity or simply close out an older fund.

"The opportunity to exit this way really emerged when the dot bomb occurred. Today, the bottom line is sellers want liquidity and the secondary market provides it," says Christopher Mayo, a principal in charge of secondary activity with Probitas Partners. "Exiting, no matter how a firm does it, is meant to show limited partners a win."

Although concrete numbers on direct secondary market deal volume are hard to come by because of the secretiveness and the fact that the business is only about 10 years old, Saints Capital, a direct secondary buyer, estimates there is about $8 billion to $10 billion of direct secondary volume per year.

To be sure, that represents just a blip in relation to the activity of the total M&A market. However, the space, industry pros say, is undoubtedly ready to take off. Most active players admit that while things have been busier, they are not frenzied -yet. "There's a lot of noise right now, but there's a difference between noise and what's been completed," says David Wachter, a founding partner at W Capital Partners. "The number of deals getting done is not as high as the press will lead you to believe at the moment."

A number of factors, though, are conspiring that should bolster deal volume over the coming years. This is having a synergistic effect, as more players are entering the market in anticipation of the opportunity. The low hanging fruit for many are expected to come from private equity firms sitting on stagnating portfolios. They may have companies that don't necessarily face bankruptcy, but also have little chance to reach bubble era valuations by the time the lifespan of the fund lapses. Rather than waste resources or time, some sponsors may be inclined to just shuttle the underperformers out of their funds so they can turn their attention to more appealing opportunities.

This is an option GPs will consider even more closely when it involves companies in industries that are at the wrong point in a cycle or have products that are capital intensive and face long product development lifecycles. Omega Funds, which specializes in the healthcare sector, for instance, has seen a substantial increase in the number of portfolios that are being put on the market. The firm, in October, announced three new deals, the most significant being its acquisition of Lombard's healthcare portfolio, comprised of nine life sciences companies based in Europe and the US. Three of the companies are publicly traded.

Some are expecting that new direct secondary investors will emerge from general partnerships that can no longer raise a traditional fund. "This is a niche within a niche and the opportunity hasn't quite arrived yet, but it's coming," says Mayo. "Investors that can't raise traditional funds might see this as a good opportunity."

Indeed, there are many similarities. For instance, most direct secondary deals come complete with board seats and advisory roles. "Once we buy a position we take a traditional role with company. We help the company grow and we sit on boards. We do everything that traditional investors do, we just entered through the side door," says Scott Halsted, a managing director with Saints Capital.

Otello Stampacchia, an advisor for Omega, is already seeing an increase in competition. Stampacchia says that Omega has recently been out bid by more than 35% by a newcomer to the asset class. "It was a little insane," he says. "The traditional secondary market saw a massive increase in players and we will see an increase in people trying to play in this space."

Halsted agrees. "We think it is true that people won't be able to raise funds and we expect some of them to enter the direct secondary market, but it requires a skillset on how to source investments and deal with complex situations," he says. Halsted identifies that the new entrants may understand how to value one business, but figuring out how to properly value anywhere from 10 to 30 properties as part of a single deal is completely different.

"There's this notion that it's easy," says Wachter, who adds that many new entrants will also face the challenge of not having a committed fund. "A firm might be able to complete a one-off deal, but it's not really a business where you can find one deal, lock it up and get it funded. It does take long-term commitment."

Mayo, however, notes that many direct secondary buyers will raise capital on an as-needed basis.

Additionally, many direct secondary deals do not depend on leverage to get the deal done - obviously important in today's current environment. "Most firms don't leverage at the fund level. Within the portfolio there may be some companies with leverage, but that depends on the buyers' risk appetite," says one player.

The market is also viewed as attractive because the discount on portfolio companies can be significant. Halsted notes, for instance, that a firm may get a 50% to 60% discount to the carrying value when buying a grouping of portfolio companies. Of course, he adds the caveat that both the buyers and sellers understand that the carrying value is likely overstated due to a "lag effect," in which private equity company valuations tend to trail the public market in terms of adjustments. Thus the true discount, based on what the carrying value should be, may be closer to 30% to 40%, which is still quite a deal.

In this market, the driver no matter what the discount is that many sponsors just need to sell. And as the vast majority of limited partners face liquidity issues, when fund lives near expiration, the demand for direct secondary buyers will continue to grow.

"A lot of sellers look at things and say, 'let's sell this and get back to our lives.' It is better to get something then to get nothing for the asset," says Mayo. "To sell an underperformer is to make a proactive decision in many cases. The rest of the portfolio could be doing great and getting rid of the one underperformer could make a positive difference."

Despite the stigma that may be attached to selling a chunk of a portfolio at a discount, many LPs who have made co-investments in recent years are not as concerned about appearances. When the Carlyle Group, Clayton Dubilier & Rice and Merrill Lynch bought Hertz the consortium set up a co-investment vehicle for their LPs. Eventually the direct co-investors wanted out, so it sold its stake to W Capital. "The LPs got their liquidity and we became a co-investor. It was good for everyone," says Wachter.

GPs who take pride in their ability to turn things around may be less inclined to think about the direct secondary option initially. However, the sooner they act, the more value they may be able to recoup.

And Halsted notes that there is no shame in using the direct secondaries market to exit, especially not after the markets turned almost overnight. "The world didn't know what was coming, which immediately made this industry more understood," he says. "The big thing here is that there is a third exit option out there and it's an acceptable one."