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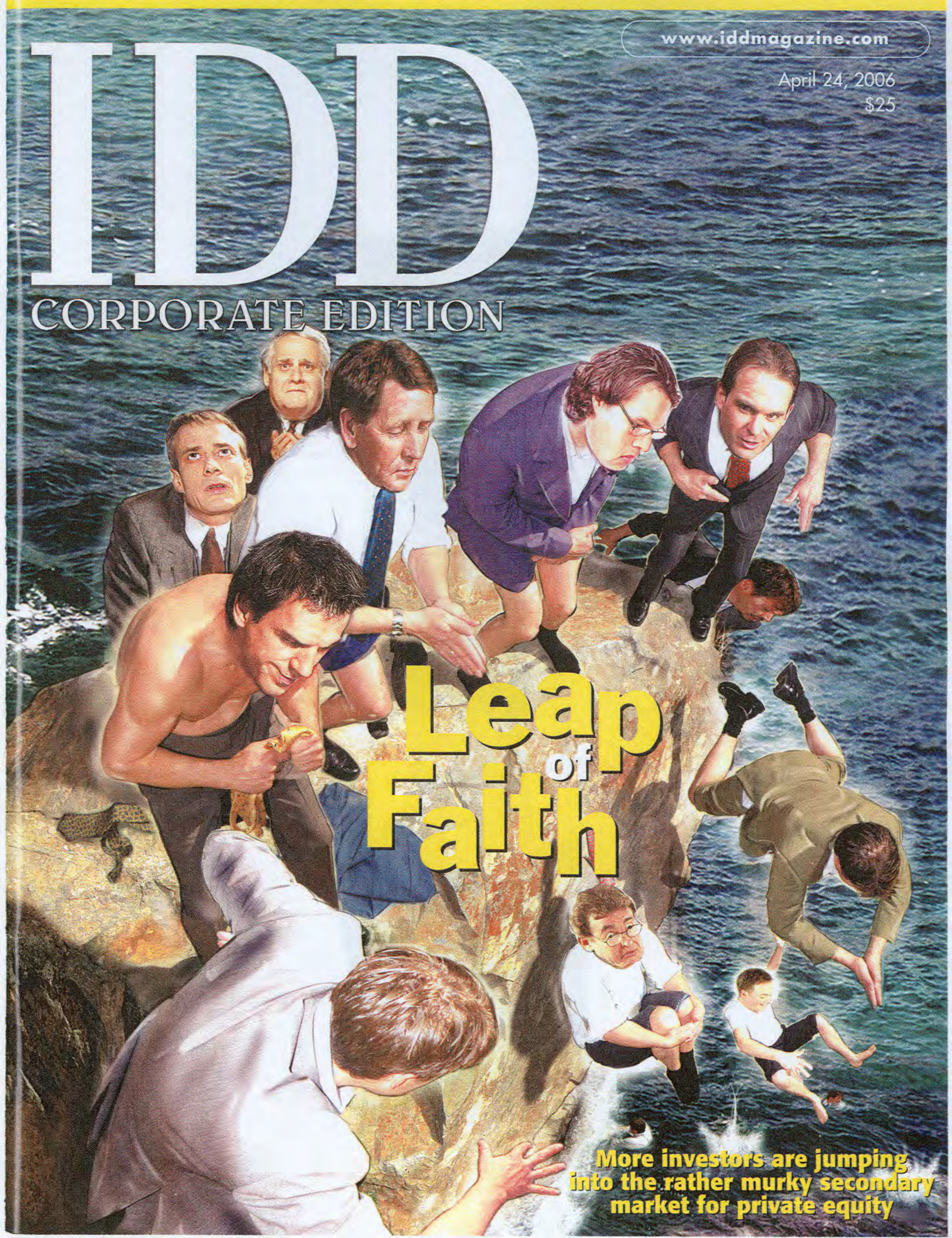

Leap of Faith

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By Suzanne McGee

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For the better part of two decades, the much-ballyhooed secondary "market" for private equity investments has struggled to live up to the moniker. Throughout the '80s and into the late '90s, it was more of a cottage industry–the exclusive domain of a handful of specialist firms that acquired partnership interests in existing venture and buyout funds. Between 1990 and 1997, a mere $3.6 billion was raised by all of the players in the market combined, according to estimates by participants.

As the buyout business flourished in recent years, however, the secondary market more than kept pace. Dedicated secondary funds now routinely top $1.5 billion.

The secondary private equity market that is taking shape today is more than simply a larger version of that of five or 10 years ago. The business is in the midst of a sea change–and a shift in the balance of power between buyers and sellers. But despite increasing liquidity, the market remains extremely opaque. And for the most part, general partners prefer to keep it that way.

The main fuel for change has been an influx of new money. Over the past few years, it has become clear that the secondary business is extremely lucrative, since assets can often be picked up at a discount. Landmark Equity Partners III, a fund formed in 1993 to invest in buyout partnerships, has generated an IRR of 35.7%, according to data disclosed by Calpers. The IRR of Coller International Partners IV, a 2002 fund, approaches 29%. As a result, new entrants and existing players have raised more capital and competition for classic secondary transactions has surged.

Naturally, this has made for more of a seller's market. And as demand and liquidity have increased, sellers' motivations have evolved. Rather than simply dumping underperforming assets, says David Tegeler, co-chair of the private equity group at law firm Proskauer Rose, today investors are more likely to be using the secondary market to fine-tune their exposure to venture and buyout funds. "They may have found that good performance has taken the weighting in private equity well above the target asset allocation," he says. "Or a new chief investment officer may decide to have more of that allocation in venture funds and less in buyout funds. Or they may want to free up capital to invest in new primary funds, or decide that they are going to invest in 10 new funds but don't want to manage 10 more relationships with management groups, so they may want to cut some existing firms from that portfolio."

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With the growth in participants, "every time a significant portfolio comes onto the market, it's not unusual to get 12 to 15 interested parties, and you might end up with five bid letters," says Tegeler. "So there is a big incentive for buyers to get in the door early, to seek out opportunities that others haven't spotted, or to persuade a seller that they can add more value in the transaction."

Farther Afield

If only to protect themselves from the onslaught, sellers are increasingly turning to intermediaries for advice. "Our calculation is that of the $7.5 billion in global secondary deals done last year, just shy of 45% of these were handled through advisors," says Colin McGrady, managing director of Cogent Partners, a Dallas-based advisory firm that counsels institutional investors on the secondary private equity arena. Cogent was established four years ago to address what McGrady viewed as a "knowledge gap" on the part of sellers. "Previously, it was hard for sellers to determine whether they were being offered a reasonable price," he says.

The increased competition has naturally meant higher prices, reducing the expected returns of buyers. That has driven some funds to look farther afield. Coller recently completed its first transaction in India, snapping up a 15% interest in a private equity fund managed by an Indian bank. Others instead have looked to new types of transactions, moving beyond the classic purchase of limited partnership interests in a portfolio of funds. "We'll come up with structures that meet whatever the sellers' needs are," says Michael Granoff, president of Pomona Capital, another longtime secondary market fund.

In a particularly complex case, secondary player HarbourVest Partners last year structured a multiyear joint venture with UBS in which HarbourVest took on the risk associated with a private equity portfolio. UBS did not want to sell the portfolio, but instead wanted it to generate a bond-like flow of cash. "We structured the terms so that we get the bigger upside potential in return for providing a downside cushion, and ensuring the bank gets the income," says Fred Maynard, managing director at Boston-based HarbourVest.

Pretty much anything and everything is ripe for consideration. "We are pushing the boundaries of the definition of a secondary transaction to include kinds of deals we hadn't thought of before," says Coller's Morgan. These new types of deals are chiefly ownership interests in private companies–which were such anomalies as recently as 2002 that they didn't register on the radars of large secondary funds. But they now account for 25-40% of new transactions for funds such as Coller and HarbourVest. Indeed, some market participants predict a bifurcation of the secondary market into the classic business of buying partnerships and the new market of direct, or "synthetic," secondary private equity investing.

In this new business, buyers end up owning direct stakes in the companies themselves rather than becoming a limited partner in an existing fund. Small-scale

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transactions of this kind have been intermittent for several years, but big banks have more recently jumped into the game with such transactions as the €1.5 billion sale by Deutsche Bank of 80% of its late-stage private equity portfolio to MidOcean Partners, an acquisition vehicle. The deal, financed by a group of veteran secondary investors that include Coller, HarbourVest and Paul Capital Partners, plus institutional players such as a variety of Canadian pension plans and Northwestern Mutual, left the buyers as new owners or part owners of companies ranging from Jefferson Smurfit to Jenny Craig.

The "new, new thing"

Direct secondaries are "the new, new thing," says Proskauer's Tegeler, who adds that such transactions land in the market for a number of reasons. "Sometimes the sellers are companies that had an in-house corporate venture program, but the strategic focus has shifted and they want to sell their stakes in those companies. In other cases, the seller is a venture or buyout firm that has one or two companies left as 'tail-end' holdings in an older fund, or a fund group where a key manager with a specialization in, say, healthcare, has left the firm."

These transactions present a host of new challenges for would-be buyers, however. The MidOcean transaction took seven months to complete and, at HarbourVest alone, required five people working on the project full-time. In MidOcean's case, managers came along with the portfolio companies and serve as de facto general partners, managing the assets on a day-to-day basis.

Sometimes, however, secondary funds have to bring in new managers. When Coller snapped up a portfolio of direct investments from AEA Technology last September for £40 million, Morgan and his colleagues turned to London-based Nova Capital to serve as general partner and manage the portfolio. "There is no lack of opportunities on the traditional side of the secondary market, but this is the part of the market where we can have a competitive and price advantage, as long as we can solve issues like this," says Morgan.

The direct secondary business is spawning a new kind of fund dedicated specifically to that segment of the market. While firms such as Goldman Sachs and Coller do all types of secondary private equity deals, David Wachter, founder of New York-based W Capital, formed his company in 2001 to acquire portfolio companies from overextended venture and buyout funds stymied because their traditional exit strategies–IPOs and acquisitions–were closed off. "These investors couldn't just sit around waiting for that activity to pick up," says Wachter, noting that the IPO market still has not fully come back and that merger valuations in some sectors remain unexciting. Wachter has raised a total of $300 million and so far acquired 19 portfolios of direct stakes. In contrast to a traditional secondary fund, he and his team manage those assets themselves. "We see ourselves as taking over and starting the time clock again for companies that need more time to realize their potential," he adds.

Although secondary funds are branching out in all directions, they still have to carefully balance the desires of general partners of primary funds. In practice, while general partners can always turn down transactions, this rarely happens. But the threat looms large enough that a big selling point for a secondary fund is its ability to claim

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that it can close on a purchase within a few weeks and that it has never had a GP refuse to sign off on a transfer.

This has become an issue for some new types of transactions brought to the table in recent years. For example, a push to securitize portfolios of private equity limited partnerships and portfolios began in 2002 but has been unable to gain much traction, largely because general partners view them unfavorably. David Schwartz, a partner at law firm Debevoise & Plimpton, says general partners "have a bias against such transactions," in part because they often require a credit rating–and the process of getting that rating opens up the private equity fund and its assets to a lot of scrutiny by rating agencies. "At the end of the day, the general partners retain a lot of

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power in this market because they have the ability to turn down a secondary deal at any point."

Knowledge gap

In this increasingly competitive and complex market, with both limited partnerships and direct interests on the block, due diligence has become even more crucial for secondary buyers. Moreover, as valuations have crept higher and discounts become largely a thing of the past, there is less margin for error. "At first, there was the conception that the buyer was always the winner, but now it is becoming clearer that yes, you can actually lose money on these transactions," says Jerry Newman, president of New York-based Willowridge, a secondary fund that specializes in buying smaller partnership portfolios.

The difficulties of conducting due diligence are one of the key factors that may constrain the growth of the secondary private equity market

Newman is accustomed to doing extensive due diligence on the companies underlying the private equity partnerships he is contemplating buying. He admits, however, that he still usually has a knowledge gap relative to the seller. "The reality is that I will never know everything the sellers might know or the general partners might know–they have lived with those assets for five or six years," he says.

But he is encountering new kinds of risks in this evolving market. For instance, as private equity shops raise more and different types of new funds more rapidly, they might need to shut older funds, selling off portfolio companies earlier than they might have done in past years. This can hurt returns, especially for secondary funds that only recently bought into an older fund. "We can assess what a company will be worth if it is given time to ripen," says Newman. But if a general partner needs to close a portfolio, "we may not be able to capture all that upside," he says.

The difficulties of conducting due diligence are one of the key factors that may constrain the growth of the secondary private equity market. "This business isn't like running a market-neutral hedge fund; the concept is easy to grasp," says Pomona's Granoff. But the nature of the private partnership structure creates "a huge barrier to efficient execution. Each part of the transaction is hard to accomplish because of this."

In fact, Granoff argues, as the market continues to grow and the range of transactions expands, it may actually be becoming more opaque. "This may be the only liquid market out there to be able to say that the trend is toward less transparency as it evolves, rather than more," he says.

Despite the efforts of firms such as Cogent, even the flow of transaction data remains imperfect. General partners may want to keep secret even the fact that a secondary sale of an interest in one of their funds took place. They certainly don't want any details of valuations to leak out, in case other investors in the fund seize on a transaction done at even a modest discount to question the general partners' valuation calculations.

Since GPs have the last word on transactions, buyers have no leverage to compel more transparency. "I don't see their willingness to share information getting much better," says HarbourVest's Maynard, which he argues will prevent the market from becoming as efficient as it otherwise might.

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But while the market remains inefficient, Pomona's Granoff rebuffs those who see that inefficiency as a source of easy profits, just as he disagrees with others who believe that secondary private equity is now so mature as to be boring. The truth? "One side is underestimating the maturity of the market, the other is overestimating it," he argues. "Personally, I think we're in a sweet spot in the middle today." **IDD**