

SPECIAL:
SECONDARIES

Pressure release

With GPs in the venture space increasingly forced to examine liquidity options, secondary buyers are reporting encouraging deal flow. By Andy Thomson.

On its website, UK venture secondaries business Shackleton Ventures reveals that it owes its moniker to Sir Ernest Shackleton, the explorer celebrated for pulling off the near-impossible rescue of his entire 28-man crew after their ship became trapped in ice during a voyage to the Antarctic in 1914. The lesson of his heroics is, we are told: “never give up”.

It may seem ironic therefore that Shackleton Ventures’ business is apparently predicated on the willingness of GP groups to give up their hold on portfolio companies. Notably, in June this year, Shackleton acquired nine assets from 3i, having already picked up four from the same source just a few months previously.

For Shackleton and all other firms targeting direct secondary purchases in the venture space, deal flow from GP sources is reported to be coming to the boil. Partly, says David Wachter, founding partner of New York-based direct secondaries specialist W Capital Partners, this is a consequence of private equity firms’ increased recognition of the liquidity option that firms such as his can provide.

He says: “What’s happening is that direct venture and private equity secondaries have moved beyond concept and become a real market. Private equity GPs now understand liquidity is available. Until recently, the perception of the direct secondary



Wachter: ‘beyond concept’

market was that it was all tail-end investments sold at a deep discount, which is actually all the market was ten years ago. But selling private equity assets to firms like us is quickly developing into an accepted strategy and, as a result, the market has changed and is growing dramatically.”

Equally, at the same time as sellers have become more aware of the secondary exit route, pressures to divest have been mounting. Some of these pressures are self-imposed. At 3i, for example, the firm’s decision some years ago to focus on fewer but larger deals led inevitably to a greater focus on what action to take with respect to its existing portfolio of small, minority investments. 3i’s website refers to “helping to evolve the ownership structure” as one of the ways of dealing with this legacy portfolio. For secondary direct investors, that’s code for deals waiting to happen.

Shackleton managing partner Hugh Stewart says the key to converting such opportunities is “developing a good rapport” with both the GP and management teams. The former may be “nervous about you tramping round all their assets and then not executing on the deal” while the latter “may have an initial perception that there is no benefit to them: they’re just swapping one shareholder for another”. The speed with which Shackleton moved from its first deal with 3i to its second suggests that such concerns are far from insurmountable.

Hopes are high that 3i’s repositioning may not be the last to slew off secondary venture deals in its wake.

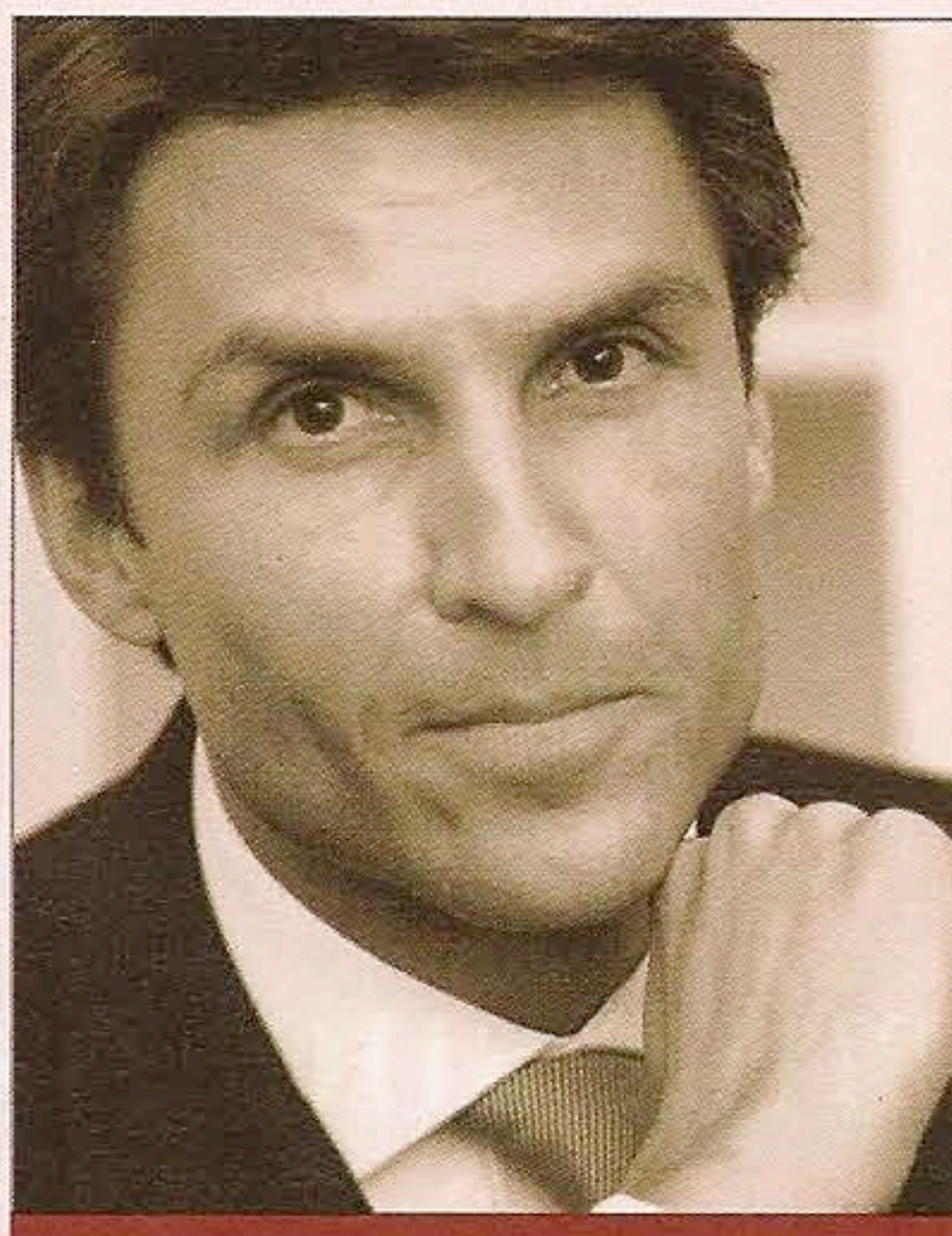
Reports that Apax Partners' new fund will focus exclusively on buyouts has encouraged much speculation among secondary investors regarding the possible fate of that firm's extensive back catalogue of venture investments.

CREATING A LEGACY

But while voluntary strategic repositioning accounts for some of the deal flow generated by GPs, pressure stemming from fundraising conditions is cited by many market participants as the most significant dynamic in the market today. One type of pressure is that experienced by brand-name venture groups whose ability to add considerable fresh sums of new capital in relatively short order has had the unintended consequence of building up a large stable of legacy assets that may stretch resource at the GP to the point where these assets can no longer be effectively managed.

Tom Anthofer, managing partner at venture secondary specialist Cipio Partners, says: "The primary VC business model has changed – bigger funds, faster deployment, and shorter fundraising cycles. By default, GPs must focus on the winners in their portfolio and will naturally pile up quite a number of unrealised companies in the process. At some point, that unrealised lot will have to be addressed, and new fundraisings are often a trigger when that happens." He adds: "As there are quite a few funds being raised, there are several GP/LP dialogues exploring how to generate more exits out of existing portfolios."

Menlo Park-based New Enterprise Associates provides a useful illustration of the speed with which some venture GPs are accumulating fresh funds (and consequently new assets). The firm has raised a total of 13 funds since 1981. The last of these prior to the bubble was a \$310 million vehicle, which closed in



Anthofer: fundraising triggers deals

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1996. Since then, it has raised approximately \$7.6 billion (including vehicles raised for follow-on investments). In 2000, it closed a \$2.3 billion fund; in 2003 it raised a further \$1.1 billion; and then last year added another \$2.5 billion.

For firms like NEA, realising legacy assets would be easier in a flourishing exit environment. However, statistics suggest something of a crush at the exit door. Sarbanes Oxley has made it difficult for young companies in the US to float on public markets, while M&A activity in the venture space has been subdued (National Venture Capital Association figures show venture-backed M&A activity in the States declining to 67 transactions in the second quarter of this year from 95 during the same period last year).

Statistics produced by Dow Jones/VentureOne underline the extent of the bottleneck. Of the 4,757 US firms that received venture capital in the bubble years of 1999 and 2000, just 128 (2.7 percent) have achieved an IPO since. While most have either subsequently gone out of business or been acquired at a knockdown price, it is estimated that 1,422 (around 30 percent of the total) were still sitting in VC groups' portfolios at the end of April this year.

From a value perspective, it would be optimal to exit these assets piecemeal. The statistics show how difficult this is to achieve in reality. Says Anthofer: "For choice assets, you will certainly realise a better price selling one by one. However, when faced with the challenge of realising an entire portfolio, individual sales are hard to complete within a reasonably short timeframe and, worse, you'll likely be left with a number of less attractive assets that require significant efforts to dispose without the opportunity of premium pricing and without a clear endpoint."

He continues: "The questions GPs concerned are asking themselves are: 'Is the secondary direct market attractive enough price-wise to allow me to clear the unrealised inventory?' and 'What will the impact on my relationships with portfolio companies, co-investors and executives be if I were to use that route to exit?'"

To those which might delicately be described as 'non-brand name' investors in the venture space, such questions might be considered something of a luxury. One source canvassed by PEI expresses the view that only 20 percent of European VC groups in the market today can be confident of raising another fund at some point in future: not surprising, perhaps, given the severe burns inflicted on many limited partner fingers by the dot-com crash.

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WRONG KIND OF EXIT

In common with the out-performers, under-performing groups also find their resources under strain: but whereas in the former case this is due to the addition of assets, in the latter it is often the result of personnel turnover. Says Grant Roberts, a partner at London-based private equity advisory business Newgate CSP: "When you can't raise new money, your business model comes under pressure and members of the team leave. This creates huge pressure on the available resource to manage the assets properly and the upshot is that you get portfolios of direct investments coming onto the market."

In funds such as these, limited partners may play an active role in precipitating transactions. Observers of the venture space in Europe say they have seen a trend towards greater activism as fund investors seek to extract what value they can from portfolios that have gone through the boom and subsequent crash.

One adviser says he has witnessed both "carrot" and "stick" approaches applied by limited partners to fund managers depending on the circumstances.

The "stick" approach was used most notably in the case of Albemarle Private Equity in relation to the London-based venture capital group's £44 million third fund, which it had raised in 1996. In light of the fund's poor performance, around 90 percent of limited part-

ners reportedly came together to force the removal of the incumbent GP. In July 2004, the portfolio was sold to Nova Capital Management, a direct secondary investor.

At the time, the deal was considered a potential trigger for a radical restructuring of the European venture capital industry amid visions of a wave of fund managers bowing to pressure from investors and offloading assets in bulk onto the secondary market. However, the LP agreements struck in the late 90s were in many cases GP-friendly, lacking terms commonly found today such as no-fault divorce and key man. As a result, even the most activist of LPs could have been forgiven for concluding that the time and effort needed to try and impose their will on recalcitrant GPs was simply not worthwhile.

LESS DISTRESS

In any case, times have moved on since the Albemarle negotiations three years ago – and there now appears to be some light at the end of the tunnel even for the under-performers. Many venture assets that survived the dot-com crash have since moved into profitability and, in general, say market participants, venture portfolios – while not perhaps in rude health – are nonetheless not as distressed as they were a few years back.

In this environment, LPs are more likely to dangle carrots than wield sticks. The "carrot" may take the form of limited partners dropping

hints to a GP that trimming the current portfolio could encourage them to back a successor fund (particularly if it involves achieving a profitable exit or two).

On the other hand, LPs might support a GP as it seeks to grow rather than scale back, in the process perhaps becoming a buyer of secondary assets rather than a seller. This was the case midway through last year, for example, when London-based Bioscience Managers acquired a portfolio of non-core assets from Denmark's Nordic Biotech for \$25 million. Deals such as these prompt Shackleton's Stewart to declare: "There's more likely to be a good reason [for a secondary venture transaction] than a bad one."

The prospect of LP intervention of any kind, observers point out, has been weakened by the outsize returns garnered from their overall private equity portfolios in recent years, driven primarily by windfalls from LBO funds. When times are good, why worry about going the extra mile to squeeze value from a part of the portfolio that's relatively small and growing smaller?

That of course could all change given mounting evidence that the top of the buyout market has been reached. But from the perspective of secondary buyers in the venture space, such a development would not be of pivotal importance. After all, they're not relying on any fundamental shift in investor sentiment to precipitate deal flow at some point in the future. They claim to have plenty of it already. ■