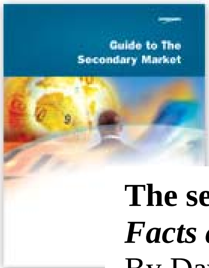

The secondary market for direct private equity investments
Facts and misconceptions of a rapidly growing asset class
By David Wachter

Only six years ago when the venture industry was sagging under the weight of thousands of under-funded companies, the idea of selling an investment was completely unheard of. Today, there is a robust secondary market for direct private equity investments. Over the past several years, private equity and venture investors have recognized the benefits of a liquidity option and the 'direct secondary' market has become a sustained asset class now entering a phase of institutionalization. We have seen this progression to increased liquidity with other asset classes including, most recently, fund LP interests and sponsor-to-sponsor transactions in buyouts.

Most private equity and venture funds have a finite life that was intended to encompass the investing and harvesting periods of a portfolio. However, volatility in the exit markets, increasing levels of capital required to finance companies to exit, and rising enterprise value thresholds to go public or complete a strategic sale have made timing and budgeting for exits difficult for managers. The development of the direct secondary market was a natural step in the evolution of private equity. Minority shareholders now can control the timing of investment exits and realizations. The secondary market gives investors an effective tool to manage returns, risk, time, capital and human resources.

W Capital Partners, a firm I co-founded in 2001, is a substantial provider of direct private equity liquidity. The firm has completed approximately 50 portfolio acquisitions, manages over $1 billion in committed capital and holds investments in 150 portfolio companies. W Capital has worked with many of the world's leading general partners who utilize the direct secondary market to proactively manage their portfolios. These firms recognize the constraints inherent in private equity fund management due to the fixed duration of a fund and preset limits on committed capital. They tap the secondary market to better control exit timing and portfolio budgeting.

Clarifying misconceptions

There is a high level of interest in this market; however, there are a number of recurring misconceptions to clarify.

The direct secondary market is driven predominantly by healthy, ongoing investors, not distressed, end-of-life partnerships. In fact, the significant majority of W Capital's transaction counterparties are established, long-term participants in the private equity market.

This is not a market driven by buyers looking for quick flips. The buyer is no more able to create an exit event than the original investor. Buyers must be prepared to work with portfolio companies as a value-added shareholder, board member and provider of follow-on capital, until all shareholders collectively achieve liquidity.

An investor exiting in the secondary market is not presumed by the market to be distressed. Post-transaction, our counterparties have not missed a beat in their core investment strategy or fund-raising. LPs are supportive of proactive liquidity when the timing and motivation are appropriate.

Valuations are not based on discounts to net asset value; instead they are based on company fundamentals, market conditions and reasonable return expectations. W Capital recently completed a transaction where the firm purchased investments at 10 times original cost, a value at which a general partner realized a significant gain, but also a fair value based upon the growth opportunities within the portfolio.

Portfolio company management and co-investors do not view a selling shareholder as abandoning the company. In fact, a new shareholder with a longer investment horizon and fresh capital is almost uniformly welcomed by portfolio companies and co-investors. There is certainly anxiety around the table prior to a selling shareholder identifying the buyer; however, if an investment is sold to a long-term, value-added investor whose interests align with other shareholders, the result is positive and well received by all parties.

Not all buyers are the same. Buyers have varying approaches to managing transactions and portfolio company relationships post-transaction. Those buyers with a long-term perspective have resulted in the most successful outcomes for general partners and their portfolio companies. There are a limited number of groups that have the experience and resources to provide an efficient, confidential and professional solution, and even fewer have the committed capital necessary to close a transaction.

Given the growth of the private equity industry, the volatility of the exit markets and the lengthening of the average hold period of an investment, the secondary market has become a value-added, key component of the industry. With consistent success, the secondary direct market will continue to grow as a resource and be broadly supported as an acceptable and appropriate strategy that provides general partners significantly more control over their assets, strategies and returns.

David Wachter is a founding partner and managing director of W Capital Partners, a private equity fund that acquires portfolios of direct private equity and venture capital investments in the secondary market. David has extensive experience in investment banking and private equity, having completed over 100 private financings, initial public offerings and merger and acquisition transactions. Prior to W Capital, David held senior roles as an investment banker for 15 years at Lehman Brothers, Jefferies and Unterberg.