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Secondaries: a diversifying market: With yet more money flooding into the secondaries space, talk has again arisen that the market is close to saturation point. But what this debate often overlooks is the changing nature of the secondaries market, which is becoming less about the sale of distressed assets and more about active portfolio management. And as sellers' needs have changed, so buyers have developed new strategies. Tom Allchorne reports

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The discussion, and worries, about the amount of money pouring into the secondaries market has been around for almost as long as secondary buying became mainstream. According to figures published by Thomson Financial Venture Economics and Campbell Lutyens, since 1992 the amount of secondary funds raised as a percentage of primary funds has risen from below 1% to almost 8%. The concern is based on whether this level, which is at an all-time high, will level off before it's too late. The bulk of assets now being traded are being sold by groups who bought in the dot.com days and now want to sell, often at a discounted price. By 2005, most of the tech bubble assets will have been sold and the argument goes that between 2005 and 2009 deal flow is going to slow substantially.

Tim Jones, partner at Coller Capital, says: "The question now is: is the market going to sustain?' Secondaries a few years ago was quite an easy game, you were almost guaranteed returns. Now the jury is out. There is a lot of money to invest and valuations are far more difficult. There is a real risk now that you could lose money."

While there will always be managers paying over the odds for something, it is usually the newer players who are more at risk of overpaying. The hype surrounding secondaries has attracted a fair few of these, and no-one will be shedding a tear if a new entrant is stuck with an underperforming portfolio on his hands because he paid too much for it. There are still distressed sellers out there and there always will be those managers who need to get rid of assets which either aren't performing as well as expected or need to sell because the core business has hit rough times or simply because the assets don't fit in with their portfolio anymore.

The phrase on everyone's lips at the moment is active portfolio management: secondaries as a service not just for the desperate but for those who want to manage their portfolios.

"It is normal to manage asset allocation," says Charles Soulignac, CEO and chairman of Fondinvest Capital. "You sell, you buy. It is the life of the asset."

Michael Granoff, president and chief executive officer of Pomona Capital, says: "A lot of people write about how much money is in the market, but no-one talks about the supply side. There are a lot of deals out there. Our strategy is to try and do non-competitive deals. We've had this specific strategy for 10 years and it has worked. This premise that there is a lot of money creates a perception that isn't true. The proof is that the secondaries market is big enough to accommodate capital."

Stephan Schli, a partner at Partners Group, also disagrees that there is too much money in the market: "I would counter the argument that the supply side is drying up by saying that sellers are coming to market that haven't been there before and this is because institutional investors see private equity as a normal asset class now. There have been opportunities to sell for the last four or five years, but they didn't know. Now they know or at least there are people in the industry, be it people like placement agents or buyers themselves, who can help these sellers to realise what they have."

Diversification

The secondaries market is now a fact of life and most GPs are used to the fact that sometimes LPs want to sell. There are still plenty of sellers out there who want a speedy sale to taste some sort of liquidity on poorly performing assets, and there are a few buyers out there who see the secondaries game as a way to make some easy money. But to view the secondaries market simply as a place to pick up assets from desperate sellers is to ignore the increasing sophistication of a quickly maturing market place.

What was once a definable enough term, secondaries now refers to a broad range of activities, with diverse buyers, increasingly specialized funds, and competing strategies to win deals and create returns. Capital in the secondary market undoubtedly outpaces the supply of assets for sale, but not all market participants share the same fate. The evolution of the market has seen secondaries for all practical purposes become divided into three general categories, with each segment having fairly unique characteristics:

1) Secondary generalists: large funds, generally US$500m and higher, which focus on purchasing sizeable and diversified private equity portfolios (comprising both LP and direct positions).

2) Secondary LP funds: funds acquiring strictly LP interests in the secondary market.

3) Secondary direct funds: funds that strictly purchase direct investments in private companies (either on a portfolio or one-off basis).

Perhaps the supply/demand equation is most skewed against the large secondary generalist funds and those funds acquiring LP interests. This is evidenced by recent deals where sellers have received premiums instead of discounts to NAV. Historically, secondary funds have prided themselves on being able to invest at a lower cost-basis than original investors, and indeed this is often how their strong returns were created. However, the secondary LP market has existed for over 10 years, and as a result of the recent and relatively intense flurry of activity over the past few years, has reached a point of maturity. The fact is that funds focused on buying LP interests can now do very little to differentiate themselves, with the exception of getting bigger and having more capital to deploy, as price is often the overriding determinant of winning a deal.

Secondary directs

Industry observers believe the newest and perhaps vaguest segment of the market, secondary directs, currently offers the most attractive capital supply-demand ratio. Dedicated secondary direct strategies have only recently become recognized as independent strategies deserving of dedicated fund managers. The secondary direct market is an offshoot of the broader secondaries market, and as it has become unbundled from the broader market, has begun to show an emergence of distinct niches. While this market is attractive due to its inefficiency, it is often equally difficult to place in a tidy box, both as a result of the varied strategies of the funds involved and the diverse opportunities presented by sellers in the market, often with their own unique needs. Therefore, the secondary direct market is less straightforward, at least in terms of the value-added and differentiation a fund/buyer might offer to potential sellers. Unlike the LP market, transactions in the direct market are not simply financial transfers from a distance. A fund buying direct investments must not only assume risk directly at the portfolio company level, but also have the skill set in-house to place a market valuation on portfolio companies, manage board commitments, and down the road take a role in developing exits for the investments to return capital. As such, the characteristics of secondary direct funds currently heading the market have become increasingly specialized.

Secondary direct transactions can be categorised in a variety of ways, and historically this has involved discussions of strategic versus financially-motivated transactions.

However, this framework was originally developed to answer the question of why a seller might sell and tells little about the secondary direct funds themselves, and what each strategy entails. Industry insiders believe taking into consideration transaction characteristics by asset type and strategy is more useful for understanding trends. In this light, the secondary direct market essentially includes aggregators, or funds seeking to develop a diverse portfolio at a discount by acquiring both distressed and performing portfolios and special situations funds that selectively acquire one-off companies and smaller portfolios at discount, seeking to apply operational value-added.

Aggregators

Aggregators focus on institutional portfolio sales (including strategic divestitures, corporate sales, and spin-outs of captive funds). Institutional portfolio sales, divestitures, and spin-outs have been the most common and publicly reported transactions, and are widely understood by market participants. Generally composed of transactions where a large parent sells off its investment portfolio, the rationale for such a sale may be either strategic or financial motivations, or both. Whether this segment will continue the recent historic volumes it has seen is much in question, but investment managers say activity will be consistent, as sellers shift their view of secondaries from a so-called dislocation market to an active management market.

Asset allocation changes and portfolio rebalancing have become more typical as investors discover the existence of the secondary direct market. And financial drivers for sales will always exist. But the inherent nature of developing a larger diversified portfolio dictates that aggregators cannot assume much of a role at the individual portfolio company level. Instead, the strategy is focused on financial levers, such as discounts, volume, and diversification.

One example of a secondary direct aggregator is **W Capital**, which has acquired over seven portfolios, consisting of a variety of industries and stages. The firm has recently closed on its debut fund, raising over US$250m of capital. Industry insiders familiar with the fund say the strategy is to build a diversified collection of private equity portfolios at a discount. The fund believes it faces significantly less competition for direct portfolios as the bulk of capital in the secondaries market is focused on LP transactions.

Special situations

Special situations funds tend to focus more on the companies themselves, and view the secondary market as a way to source the deals at a discounted cost basis later in the investment lifecycle (thereby enhancing returns by being able to return capital earlier, while also reducing individual company investment risk). Such secondary direct funds are focused on adding operational value to a fewer number of investments. Thus, special situation funds are generally focused on acquiring larger stakes that offer board seats, and other rights providing the fund manager some level of influence at the company level. While the deals that special situations funds pursue likely have some overlap with the aggregators, they tend to focus more on one-off company deals, and tail-end funds, where GPs are selling the remaining investments of a particular fund.

Tail-end fund sales are currently one of the more exciting features of the secondaries market, and the segment is widely expected to generate the bulk of the secondary market's growth. These sales are less recognized because they are rarely reported in the trade press, and because they have only recently begun to add up to noticeable volume. Generally, tail-end fund situations are driven by private equity GPs raising follow-on funds, and disposing of remnant portfolio companies from earlier funds (as they have largely returned their value and are an unnecessary drain on resources). This is paired with LPs demanding earlier GP funds be sold, for alignment of interest purposes (i.e. for GPs to focus their efforts on current funds, not earlier funds).

One example of a special situations secondary direct fund is recently formed Morning Street Partners. Morning Street's principals, who earlier founded and ran Columbia Strategy, (a secondaries advisory firm, which provided much of the published research on the secondaries market) are credited with developing and influencing many of the key trends currently taking shape in the secondary direct market. Sources close to the fund say the strategy was driven both by the emerging tail-end fund market opportunity, and by the principals' desire to put their operating expertise to work in performing companies that can be acquired below market value as a result of the illiquidity discount. Morning Street allocates half its efforts to buying out original investors in one-off deals involving later stage venture and smaller mid-market companies, while remaining efforts are focused on acquiring portfolios (primarily tail-end funds of GPs, rather than larger institutional portfolios). Morning Street addresses a part of the market that other secondary players have been unable to target because of the operating expertise required, and in many ways is too specialized for widespread competition.

Another example of a special situations fund is Partners Group, the Swiss hedge funds and private equity firm, which reached final close on its global fund, Partners Group Secondary, in September 2004. At EURO500m the firm said client demand significantly exceeded the cap, which had previously been set at EURO400m at its launch in October 2003, and requested allocations had to be reduced. Partners specialises in manager secondaries, which are secondary investments usually less than 70% invested and up to two to five years old, with a primary focus on European buyout funds. The firm says that younger funds have usually not experienced significant write-ups and are still in the J-curve phase. Due to reduced portfolio visibility and a resulting reliance on the fund manager's know-how, manager secondaries require expertise in primary investing where a thorough due diligence of the fund manager is critical.

Stephan Schli is chair of Partners Group's private equity investment committee, and is also responsible for overseeing the secondary investing activities of the firm. He believes manager secondaries are an untapped area in the market. He says: "In the secondaries market we have seen more active players, but it does depend in which sectors you are talking about. In financial secondaries, which are those funds which are 70% plus invested, a lot of secondary funds rushed in because they wanted more immediate results. Because of this, supply and demand is coming under increasing pressure, but much more capital has been raised from 1999 onwards in manager secondaries."

Bespoke answers

Bespoke deals are also becoming common. Rather than a buyer simply acquiring a portfolio, increasingly sophisticated sellers are looking for more than simply offloading unwanted assets. As the secondaries market has matured, so the motivations of buyers and sellers has changed. Secondaries are now a tool of liquidation. Many sellers now divest assets simply because they don't fit into their portfolio anymore. This is a point Michael Granoff is keen to make. Granoff founded Pomona Capital in 1994 and since that time has seen a definite change in the attitude of GPs towards secondaries buyers. "When I started doing secondaries, GPs at the time saw it in their own terms, but after a while they began to accept it," he says. "They recognised that an LP selling a stake in a fund is not to do with the fund itself but to do with the LP. After they accepted this they then began to realise that it could actually be beneficial and began to welcome it because they got new investors who were bringing in new capital. There has been an evolution in GP attitudes towards secondaries, and that is why you get more transactions nowadays."

Mark Mifsud is a corporate finance partner at SJ Berwin who led the team advising Goldman Sachs on its EURO400m transaction to acquire two Societe Generale Capital Europe funds and invest in a new fund to be managed by Societe Generale. Mifsud said: "The whole point of secondaries is about providing liquidity. It doesn't mean the seller is a forced seller. We need to get away from this idea. It is dynamic portfolio management. Some LPs just want to reorganise what they have got."

The two funds which were sold, SG Capital Europe Fund I and SG Capital Europe II, comprised 16 LBO investments, valued at EURO220m. Goldman Sachs and SG have also committed EURO180m in aggregate in a new private equity fund to be managed by SGCE. SCGE will also continue to manage the two funds it sold as a GP, with Goldman Sachs an investor in both.

For Goldman Sachs, the acquisition improves its exposure to the European mid-market. For SG, both the bank and the private equity team benefit. SCGE has gained a degree of freedom from its parent company, SG Asset Management Group. It has also meant that the parent bank can now adhere to the rules laid down by Basel II by moving the funds off its balance sheet. It has been reported that SCGE is looking to raise a new fund in two to three years, one which will be open to more investors.

In the same month the SG sale was announced, Coller Capital announced its purchase of a portfolio of 22 investments in North American companies from the Institutional Restructuring Unit (IRU) of Dresdner Bank for US$90m (EURO72m). The deal was described as a management spin-out, following in the footsteps of Coller's 2001 acquisition of Lucent Technologies Inc.'s New Ventures Group portfolio, arguably the landmark direct secondaries deal. Two Dresdner partners will manage the assets independently as GPs, with Coller Capital an LP.

Dresdner was acquired by Allianz AG in 2001 and has preferred to conduct its private equity investment through Allianz Capital Partners. The IRU sale is the culmination of Allianz's plans to merge all non-core assets into one unit and gradually sell them off, and has succeeded in reducing the bank's private equity exposure from EURO1.4bn in 2001 to EURO900m. This was the first time a portfolio of investments had been sold. Previous transactions had been sale of individual investments.

Bank divestments

In January Coller was involved in another of this year's standout deals in the shape of its purchase of the bulk of Abbey National's portfolio in a EURO430m sale. The portfolio was made up of 41 private equity funds and 16 direct shareholdings in European companies. Abbey's sale was driven by stereotypical selling reasons: it invested in the late 1990s, then saw the value of its investments decrease. In July 2002 Abbey announced it was reviewing its private equity fund-of-funds business following a substantial fall if profits, and in February 2003, the bank said it had decided to focus its attention on retail finance. It has subsequently sold its position in Electra's EURO1bn Europe Fund, sold around EURO700m of leveraged loans to GE European Leveraged Finance Group and divested its interest in Hutton Collins to Capital Z.

Its portfolio sale to the US$2.6bn (EURO2bn) Coller International Partners IV was a GBP59m (EURO85m) discount to the holding value of those funds in Abbey's balance sheet as at September 30, 2003. Included in the portfolio were stakes in funds managed by 3i, BC Partners, Duke Street Capital, Intermediate Capital Group, Montagu Private Equity and Warburg Pincus.

In March, ING Bank also reduced its private equity exposure. Pomona Capital took over the management of ING's US insurance companies private equity portfolio. The portfolio consists of investments in 57 funds with around US$600m in committed capital. Pomona will also build a diversified private equity programme for the ING US insurance companies by creating a customized portfolio of primary and secondary fund investments totalling US$500m over the next five years. This will create a private equity portfolio for ING totalling US$1.1bn.

"It is the banks who are biggest sellers and there is still a lot to come out of them," says Tim Jones at Coller Capital. Now is a good time to sell for the banks. Private equity valuations are improving, but the banks still aren't comfortable with having something as volatile as private equity, or venture capital to be more precise, on their books. And with many banks still recovering from the overall economic downturn of a few years ago and with Basel II, they are only too happy to sell. JP Morgan, which has US$12bn in private equity, said its plans to cut its exposure by 5% this year following its merger with Bank One, and reports have suggested that similar plans could be afoot at Bank of America following its merger with FleetBoston.

No crash

Will the current levels of transaction volume be maintained? Probably not, but no-one in the market seriously seems to believe they are all headed for a crash as some doom-mongers have been forecasting. There are still a lot of assets tied up in banks' portfolios, and as the sale of Deutsche Telekom's private equity firm T-Venture of 15 direct investments showed, corporate venture is not finished selling yet either. The next few years will see a maintenance of the status quo with regard to the main players on the scene accompanied by the emergence of smaller, specialist funds set-up to take advantage of the diverse niches of the market.