

PRIVATE EQUITY & VENTURE CAPITAL

Liquidity alternatives in direct private equity is here to stay

BY DAVID S. WACHTER

Historically, the only options for investor liquidity in direct private equity have been a public offering, sale of the company or recapitalisation. However, as the private equity industry has matured and developed, so has the range of exit options available to investors. Private equity investors now have control over the timing of exits and realised gains and losses of their assets. This provides shareholders and general partners the broad flexibility to more effectively manage their portfolio strategy.

Consider an investment that has no maturity, yield or market price. The investment is made alongside a syndicate of other investors with differing time horizons and return targets. It will almost certainly require additional capital in multiples of original cost; otherwise the original investment will become substantially impaired. The venture capital industry thrived under this investment model from its early days through the 1990s because a relatively small number of professional venture firms managed a significant component of the industry's capital and were able to access the strategic buyer and IPO markets for a healthy return within a reasonable investment horizon.

Venture market growth and the boom and bust

The dramatic growth of the private equity industry over the past decade combined with the boom and

bust cycle have been catalysts for the emerging secondary market for direct private equity and venture capital investments. During the past 10 years, more than 16,000 new companies were funded. Investors assumed that a majority of them would exit via the public markets, thereby providing liquidity and relieving funding responsibilities for cash-flow negative venture stage businesses. Of those companies, approximately 4,300 have achieved liquidity through the public markets or by trade sale. Without access to the public market, an additional 5,000 companies lost support and have been written off. Based on this, the current universe of venture funded privately held companies is approximately 6,700 today. Further, with over 1,000 new companies funded and approximately 400 exits taking place annually, the universe will continue to grow. With this expanding market a broad number of new investors entered the market including banks, corporations, insurance companies and first-time limited partnerships, many of whom did not anticipate the volatility, time horizon and ill-liquidity of the private equity market. As these participants attempted to reduce exposure to the sector, the realities of this market have become more acute, driving demand for liquidity.

Liquidity and development of the secondary direct market

Since 2001, there has been a devel-

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oping demand for liquidity in direct private equity portfolios. Corporations are participating in order to exit investments that have become non-strategic while retaining their strategic venture investments. Financial institutions are seeking liquidity in order to rebalance their exposure to private equity relative to alternative asset classes more consistent with their risk-return objectives. General partners of venture funds are interested in liquidity to proactively generate exits and return capital to limited partners as portfolios reach harvesting stage, regardless of whether the portfolio companies are mature enough for exit.

Corporations entered the strategic venture market aggressively during the late 1990s, with over 1,000 corporate venture programs established during the peak of the market. A majority of those have since wound down or exited their portfolios through the secondary market. As we return to a steady state of investing and the return of the corporate investor, corporations have begun to appreciate the secondary market as a way to proactively exit non-strategic investments and recycle capital for new strategic investments. Several of the leading corporate venture participants have come to the secondary market on multiple occasions with such a strategy and are incorporating secondary sales into their overall strategic planning.

Financial institutions including CIT, Deutsche Bank, Dresdner, Wachovia ►►

and many others have completed or are pursuing a range of alternatives to rebalance their exposure to the private equity asset class. Motivations include conflicts of interest with clients, changes in regulatory capital requirements, corporate mergers or a change of view regarding the asset class. Outright sale of the investment assets, spin-offs of private equity divisions or alternatively structured transactions are driving a material shift in ownership of those portfolios.

General partners of venture and private equity funds are accessing the secondary market for liquidity of selected portfolio investments or closing of entire funds. Due to the extended downturn, 1997 through 2000 vintage funds experienced a shortfall in capital necessary to support existing portfolio companies. As a result, these funds are reaching maturity with limited capital resources for follow-ons or management fees and have not yet returned a material component of total invested capital. General partners of such funds are considering near-term liquidity relative to their fund's long-term return prospects, limited partner expectations, the adequacy of unfunded commitments relative to follow-on capital requirements and extending the fund's maturity and annual management fees.

The effect on portfolio companies and co-investors

A sale of a venture portfolio not only impacts the buyer and seller,

but each of the underlying portfolio companies and their co-investors. A buyer in a secondary transaction can enhance or diminish value of a portfolio company as materially as any engaged or incompatible original investor. Venture investing is unique relative to most other asset classes; capital is deployed through multiple rounds of financing by investor syndicate participation with investors interdependent upon each other's capital resources and investment horizon. Misalignment of objectives between investors can cause significant challenges for private companies. The replacement of a significant original investor with a new motivated shareholder could produce a stronger, more committed long-term investor; however, an undercapitalised or short-term oriented buyer may result in conflicts regarding growth strategy and future funding rounds. While the secondary direct market is at a very early stage of development, its success is dependent upon establishing credible buyers that possess a long-term commitment and approach to supporting portfolio companies comparable to a primary investor.

Becoming a broadly supported and accepted strategy

Given the venture capital industry's extraordinary level of growth, the lengthening of the average hold period of an investment and the volatility of the exit markets, the introduction of liquidity alternatives and

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a robust secondary market is an appropriate and natural next step for the industry. Over the past decade, the average amount of capital deployed per year has grown to \$20bn, from \$3bn per year in the prior decade with total cumulative capital deployed in the industry now exceeding \$300bn. This growth is extraordinary, when considering that there had been absolutely no secondary liquidity alternative in the industry. This is even more remarkable given that investing in this sector inherently requires collaboration among diverse investment syndicates, unquantifiable reserves of follow-on investment capital and complete uncertainty regarding realisation timing or exit value.

Continued growth of the secondary direct market will be based upon the commitment of a universe of buyers to providing sellers with a reliable and consistent liquidity alternative and an efficient and discreet closing process. Those same buyers must manage their investments with the same commitment to their portfolio companies as any established primary investor. As that takes place, the secondary direct market will continue to grow and be broadly supported as an acceptable and appropriate strategy that provides general partners, financial institutions and corporate investors with significantly more control over their assets, strategies and returns. ■

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