Yet Another Way To Invest in Secondaries

Posted on: March 16th, 2009
Erin Griffith

peHUB recently laid out a number of options for investing in the very cheap secondary market, including large dedicated funds raising new pools of capital and publicly-traded funds-of-funds like Conversus Capital.

Today we present one more form of secondary investing—the direct secondary. Naturally, that includes the kind of sponsor-to-sponsor deals that some LPs frown upon, but there are several firms whose entire strategy involves taking direct minority investments off PE investors hands. They call this practice "direct secondary" investing.

I spoke with David Wachter, a managing director and founding partner of W Capital, one such firm based in New York. The firm is currently investing from its second fund, a $700 million pool of capital which closed $200 million above target in March 2008. Other players in the market include Vision Capital in the UK and Goldman Sachs' secondaries fund.

Does news of potential private equity firm wind-downs have a direct secondary fund like yours licking its chops over the potential deal flow?

Deal flow overall is very high and there are lots of situations occurring in the current environment. One dynamic is that many funds are reaching the end of their investment period. Some funds are into their carry but many are underwater. What tends to happen when the fund is underwater is that it is more difficult for the GP to raise a new fund and there becomes a developing misalignment of interests. In the past, the LPs have encouraged the GPs to stick with it and see the portfolio to liquidity. But with the volatility in the markets, the premium on liquidity, and the need for LPs to recycle capital and free up reserves-all of that is changing LPs' thought process regarding a GP proactively winding down. Given the markets, a quick sale of the assets rather than a prolonged wind-down is being seriously considered.

But a quick sale would mean fire-sale prices, right?

Hard to call it that, when the public markets are down about 50%. The issue in private equity secondaries now is that NAV isn't close to matching the NAV changes in a portfolio of comparable public companies. For LBOs, that, combined with private portfolios having leverage higher than their public party counterparts, is making alignment of expectations difficult. At this point in many LBOs, public company comparable multiples are a fraction of the private company's NAV.

So, your firm plans to take advantage of upcoming portfolio garage sales?

We don't look at it like a garage sale. These types of deals are what we look at every day. There are buyers and there's capital available. The biggest issue is that a buyer, us included, has to take a view on the markets, economy and the future of the exit environment so we can someday exit as well. Garage sales suggest that we want to own the investment forever. If there's no market for a long time, I suppose some day we may be hosting our own garage sale.

It's important to note that we don't do control buyouts. In fact there are very few direct secondary firms that buy portfolios of control-stake buyouts. Most of what we buy is portfolios of LBO co-investments, and syndicated equity interests in growth equity and late stage venture investments.

Who are you buying those co-investments from?

We buy our LBO co-investments from big insurance companies, banks and hedge funds. In co-investments, we're generally more passive, in growth and venture, we take material positions and have board involvement. We've purchased more than 50 portfolios, and that ranges from entire portfolios to a subset of a portfolio. We also buy a pro rata slice, meaning, we buy a piece of their investments in multiple companies. This lets investors stay in for future upside while taking risk off the table.

How are your investments different than some of the other large secondary investors?

The biggest difference is that we buy direct investments and other large secondary investors primarily buy LP interests. As a direct investment buyer, our business doesn't require us to commit to unfunded commitments when we purchase. Our follow-on investment decision is based upon supporting companies directly, we have more control and discretion over where our follow-on dollars are going which allows us to be somewhat more comfortable buying secondaries today.