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THE Private Equity Analyst

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Inside

Secondary Firms Start To Play a Regenerative Role in Industry

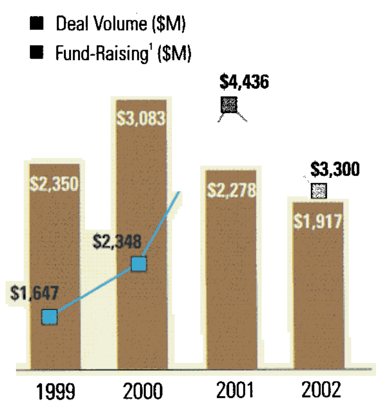
More secondary firms take on challenges of buying direct portfolios

Imagine trying to close 25 acquisitions—simultaneously. Figure on contending, in several of the deals, with minority shareholders who have the right to try to prevent the transfer of shares.

Just for good measure, let's call it a collection of mostly struggling start-ups desperate for follow-on financing. That's right: You have to get the sellers to accept pennies on the dollar for their original investments.

You have entered the secondary zone. It is a place of daunting challenges. But it is also, to hear secondary buyers describe it, one of sizeable opportunities.

Secondary Deal Volume Poised to Rebound?



1) Excludes money raised for secondary investing by managers of funds of funds; also excludes money available for secondary investing by firms that don't raise institutional funds.

Source: Lexington Partners Inc., The Private Equity Analyst

"We think this type of transaction is at least doubling the size of our target market in the secondary business," says Geoffrey G. Clark, managing director of **Goldman Sachs Asset Management,** and a manager of the GS Vintage family of secondary funds.

Mr. Clark sees at least $2 billion worth of direct portfolios coming up for sale over the next several months. Corporations continue to jettison their in-house venture cap-

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JOYS OF OWNERSHIP

Hamilton Lane Loses A Team, Gains Rival Advisory Firm

In early February, the senior management of **Hamilton Lane Advisors Inc.** told staff of plans to share equity with a broader swath of employees. But six Hamilton Lane professionals already had other plans: Being the proprietors of their own business.

Last month, the bulk of Hamilton Lane's seven-member due diligence team left to form a rival advisory shop, **Franklin Investment Advisors,** Conshohocken, Pa. Leading the new firm as CEO is Bradley Atkins, the former head of research and co-head of co-investments at Hamilton Lane.

To be sure, we have uncovered little evidence that Mr. Atkins and his crew left Hamilton Lane over not having an ownership stake in the firm. Mr. Atkins

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ital programs in belated attempts to cut their losses. Both commercial and investment banks are selling of portfolios in part for the same reason, and in part to avoid the higher cash reserves that now need to be set aside for private equity investments.

Organizations widely regarded as likely sellers in coming months include **Abbey National** (sale in process), **CIT Group, Dresdner Bank, Fleet Boston Financial Corp., GE Capital, Hewlett-Packard, J.P. Morgan Chase & Co.** and **UBS AG.** "A lot more of these [deals] will start unfolding over the next six to nine months," says Jay Pierrepont, in charge of secondary buys at **Pantheon Ventures Inc.,** San Francisco.

This year has already seen several transactions of this kind. In what some are calling the largest secondary deal ever, **Deutsche Bank AG** earlier this year sold an 80 percent interest in a $1.5 billion portfolio to a large consortium that included **Canada Pension Plan Investment Board. EDS** this March sold a corporate venturing portfolio to **Thomas Weisel Partners,** San Francisco and **Willowridge Inc.,** New York. As part of a deal with an estimated value of $25 million, **Tredegar Corp.** earlier this year sold a corporate venturing portfolio to **W Capital Partners,** New York, a firm with backing from Goldman Sachs Asset Management. Goldman Sachs Asset Management alone anticipates investing several hundred million dollars from its 2000 fund to acquire direct portfolios, according to Mr. Clark.

Still, why care about a backwater of the secondary market that remains so complex that only a handful of secondary firms make it a major specialty? After all, the secondary market still is largely driven by the sale of interests in limited partnerships, not the sale of direct portfolios. One big reason is that the direct portfolio deals are playing a regenerative role in an industry undergoing its worst shakeout in more than a decade.

We're seeing more and more instances where a competent and credible investment team has assembled a portfolio of investments that its parent company wants to part with. Rarely does the team have the wherewithal to buy the portfolio. But secondary buyers, often operating as part of syndicates, do.

Buyers may see an opportunity not only to acquire a portfolio on the cheap, but also to put the management team into business as an independent team on favorable terms. Often the secondary buyers can negotiate budgeted management fees, or a performance-based carried interest that steps up from a below-market floor.

Backed by secondary buyers, those teams that develop strong track records can hope to have long lives as independent firms that raise institutional funds. *The Private Equity Analyst* has identified at least four such groups with fund-raising aspirations: **MidOcean Partners,** a New York buyout shop; **New Venture Partners,** a Murray Hill, N.J., venture firm; **Peachtree Equity Partners,** an Atlanta buyout firm; and **Quantum Technology Ventures,** a Santa Clara, Calif., venture firm (see table, page 50).

Several firms have also sprung up to take over management of portfolios in cases where the investment team needs to be replaced. Three of them, **Protostar Partners,** New York, **Vision Capital,** London, and W Capital, have done deals backed by Goldman Sachs; others occupying this niche include **Industry Ventures,** Boston and San Francisco, and, again, MidOcean Partners. Expect many of these firms also to raise institutional money in the years ahead.

For these and other firms willing to brave the challenges, the rewards can come quickly. In a late 2001 deal that still inspires reverence, **Coller Capital,** London, acquired a 27-company corporate venturing portfolio from **Lucent Technologies,** Murray Hill, N.J., for just under $100 million. Only five months later, Andrew Corp. snapped up portfolio company Celiant Corp., a maker of radio power amplifiers, in a $470 million transaction. Just like that, Coller had gotten 1.6 times its money back in a single exit.

The Lucent deal has inspired more than a few buyers to look at the secondary market for direct portfolios more closely. By the same token, it also served as a wake-up call to sellers to make sure they know what they're leaving on the table. Still, such early and giant home runs are not the rule for those acquiring direct portfolios. (Coller has had only one other exit to date from the portfolio.) And buyers face enormous challenges in getting these deals to work, including the following.

Complex due diligence. "You have to develop an understanding of the businesses, and the securities across dozens of companies to close one transaction," observes David Wachter, a partner at W Capital.

Concentration of risk. Acquire a large portfolios of limited partnership interests and you may well be getting, in effect, shares in 1000-plus companies. By contrast, direct portfolios typically consist of interests in anywhere from five to 100 companies. In many cases,

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New Investment Teams Backed by Secondary Buyers

Industry Ventures | Boston, San Francisco, (978) 499-7606
Select secondary backers: Thomas Weisel Partners, Willowridge Inc.
The Deal: This March the firm took over the four-year-old corporate venturing portfolio of **EDS** in a deal believed to be valued at far less than $100 million.
Fund-Raising Plans? Unclear.

MidOcean Partners | New York, (212) 326-6721
Select secondary backers: Canada Pension Plan Investment Board, NIB Capital, Ontario Teachers' Pension Plan Board, Paul Capital Partners
The Deal: Earlier this year the firm spun out as an independent firm from Deutsche Bank AG to manage an 80+ portfolio of control and non-control investments in consumer products and business services companies. Deal valued at $1.5 billion.
Fund-Raising Plans? The firm expects to start raising its first institutional fund before the end of the year.

New Venture Partners | Murray Hill, N.J., (908) 582-0915
Select secondary backers: Coller Capital
The Deal: New Venture Partners spun out as an independent team from **Lucent Technologies** to manage a 27-company venture portfolio. Price tag: Under $100 million. The firm has since agreed to help manage a venture portfolio put together by a team at British Telecommunications plc.
Fund-Raising Plans? The firm is putting together marketing materials for its first outside fund.

Peachtree Equity Partners | Atlanta, (404) 253-6368
Select secondary backers: Goldman Sachs Asset Management
The Deal: Peachtree Equity Partners spun out as an independent team from Wachovia Corp. in mid-2002. Goldman Sachs supplied $110 million to purchase the mid-market buyout portfolio and provide for additional acquisitions.
Fund-Raising Plans? The firm is expected to raise an institutional fund within a year or two.

Protostar Partners | New York
Select secondary backers: Goldman Sachs Asset Management
The Deal: n/a
Fund-Raising Plans? Goldman Sachs convinced Protostar Partners to forgo raising a traditional mid-market buyout fund to concentrate on secondary opportunities.

Quantum Technology Ventures | Santa Clara, Calif., (408) 865-0685
Select secondary backers: Pantheon Ventures
The Deal: Quantum Technology Ventures spun out as an independent team from Quantum Corp. late last year to manage an 18-company venture portfolio. Pricetag: $11 million.
Fund-Raising Plans? The firm is expected to raise a fund from institutional investors down the road. It must wait until returning capital to Pantheon or three years, whichever comes first.

Vision Capital | London, 44-207-5940600
Select secondary backers: Goldman Sachs Asset Management
The Deal: Vision Capital in February took on management of a five-company buyout portfolio assembled by **Morgan Grenfell,** a division of **Deutsche Bank AG.** Estimated price tag: $80 million.
Fund-Raising Plans? Unclear.

W Capital | New York, (212) 355-0770
Select secondary backers: Goldman Sachs Asset Management has supplied much of the capital W Capital has used to so far to finance acquisitions of corporate venturing portfolios.
The Deal: W Capital has taken over management of four portfolios, including most recently the corporate venturing portfolio of **Tredegar Corp.** A typical purchase price falls in the $5 million to $50 million range.
Fund-Raising Plans? W Capital has set out to raise $150 million to purchase corporate venturing portfolios. **Probitas Partners,** New York, is placement agent on the fund.

Source: The Private Equity Analyst

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the interests come with rights and preferences that are subordinated to those of other venture capital firms.

Greater role in managing portfolio. After buying a direct portfolio, secondary buyers end up being in the position of the only limited partner, or one of only a handful. That means they often have to play a supporting role in fund management, helping to determine portfolio company valuations, deciding whether companies get follow-on financing, giving the OK for the fund manager to raise another fund.

An untested management team. Secondary buyers backing the original management team in a spin-out face special risks, such as that the team has not proven itself capable of operating independently, or of raising money. Adds Dale J. Meyer, a placement agent at **Probitas Partners,** San Francisco: "You're getting people that are in love with the portfolio as opposed to ones who have a dispassionate view of value."

The need to reserve capital for follow-on rounds. Secondary buyers acquiring venture capital portfolios typically have to reserve capital for follow-on financings. Anywhere from 10 percent to 40 percent of the purchase price is common.

Declining valuations. Many unwanted portfolios are worth only pennies on the dollar, and their values decline rapidly when their parents decline to participate in later rounds of financing. Secondary buyers may end up spending months on due diligence for a portfolio worth only a few million dollars. Says Jerrold Newman, founder of **Willowridge Inc.,** a New York-based secondary buyer: "In a declining market, you want to be careful, because if the market continues to decline, what you bought doesn't look as good."

Man Overboard at MidOcean

The recent spin-out of a 35-professional buyout team from Deutsche Bank AG illustrates how difficult due diligence can be on such deals.

Just a few weeks after the $1.5 billion sale closed, Charles Ayres, one of three senior professionals that had been expected to lead the portfolio at MidOcean Partners, left to take the reins at **Lehman Brothers Merchant Banking.**

The move came as a surprise to just about everyone, including one of the other three senior professionals, Ted Virtue. Also surprised: a consortium of secondary backers, including Canada Pension Plan Investment Board

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(which invested an estimated $250 million), **Ontario Teachers' Pension Plan Board** ($345 million), **NIB Capital** (345 million), and **Paul Capital Partners** ($85 million).

Says one secondary buyer that didn't participate in the deal: "I think that's an indictment of the deal already, that someone didn't make sure that guy was properly incentivized to stick around."

But Mark Weisdorf, vice president-private market investments at Canada Pension Plan Investment Board, remains confident in the transaction. "It would have been optimal if we'd known ahead of time," Mr. Weisdorf says. But given the 35-professional staff, and two of three senior managers remaining on board, "there's plenty of depth to the team," he adds.

There's also, to be sure, plenty of potential in the portfolio, an over 80-company portfolio of U.S. and European consumer products and business services companies assembled over the past five years. Backers note that Deutsche Bank chose to keep a 20 percent interest in the portfolio, and was prepared to keep 40 percent.

MidOcean already is looking ahead to raising its first fund as an independent group, possibly toward the end of the year, Mr. Virtue says. The firm also has an appetite for additional secondary sales. "We have a large team that has now been through the largest secondary purchase ever," Mr. Virtue says. "We definitely have the skill set to look at other portfolios that come on the market."

Transfer Troubles for Tredegar

Another deal that involved plenty of challenges was the sale of a 39-company portfolio by Tredegar Corp., to W Capital earlier this year.

In one hitch, management at one portfolio company was concerned about proprietary technical information being leaked out as part of the due diligence. Secondary buyers don't necessarily have to address such management concerns, but it is advisable to do so since they need management's cooperation down the road.

In another hitch, a management team and a co-investor in a portfolio company early in the process said they wanted to exercise "pre-emption" rights that let them try to outbid the secondary buyers for the shares. However, it doesn't appear that Tredegar ever seriously entertained selling the portfolio piecemeal.

Says a source involved with early talks to the CEOs of the Tredegar portfolio companies: "They were very reluctant to sell these things. It took a combination of threats/persuasion to get them to transfer." (That said, by the time the bankers had prepared the portfolio for sale, all of the CEOs were on board and helpful, according to W Capital's Mr. Wachter.)

The Tredegar management team that built the portfolio, including medical devices and IT investor Edward Brennan and biotech investor David Maki, was also helpful during the transfer, Mr. Wachter said. However, sources agree that the team would have preferred to take the portfolio with them when they spun out to form an independent firm based in Seattle.

Given the complexity of the due diligence phase, it took the 13 original bidders some eight weeks to perform due diligence on Tredegar's technology and health care portfolio, which was sold alongside of a portfolio of interests in 29 funds. Without the direct portfolio, due diligence would have taken just half as long, our source said.

Big Deals Ahead

We'd be remiss not to mention that secondary buyers have been predicting big things for their market ever since investors committed $170 billion to the asset class in 2000—the culmination of a fantastic run-up in fund-raising during the 1990s. As the table on page one shows, the expected volume of secondary deals just didn't materialize in the last couple of years.

But if the last few months are any indication, a backwater of the secondary market is about to become a major tributary. A few secondary buyers are diving in to try to make their fortunes, while others are dipping in here and there. Those with a long view of the industry may see this tributary as one channel through which the industry might return to prosperous times.

By David M. Toll

Hamilton Lane Loses Team

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says that the team left largely to take advantage of dynamics in the advisory business that have opened up more assignments to smaller firms. "There is a huge demand among investors for pure advisory services, like risk analysis and portfolio monitoring," Mr. Atkins says.

But sources close to the firm say that the departures seemed almost foreordained, given how ownership at Hamilton Lane has been concentrated in the hands of just a few top employees. And it does seem to be more than coincidental that Hamilton Lane would lose a key team of professionals just as it reached the decision to share ownership more broadly.

One of the departing team members in an interview earlier this year said that the ownership structure was an "issue" at the firm. But last month, Mr. Atkins said that it had nothing to do with his personal decision to leave Hamilton Lane, pointing out that the economic risks involved in starting a new firm are far greater than those