Dealing in Direct Secondaries

TRANSCRIPT
The following is the transcript from the video program, "Dealing in Direct Secondaries."

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Privcap: You deal in the direct secondaries market. What does a typical transaction look like?

David Wachter, W Capital Partners: Direct secondary is the purchase of shares in companies, direct interest in companies, from the original institutional shareholder. So what it's not is also relevant. A direct secondary is not the purchase of an LP interest or a portfolio of LP interests. That's a completely different market.

It's also not a typical direct private equity buyout deal where one sponsor sells an entire company to another company. What's left is what we do, and what the direct secondary market is, which is the purchase of portfolios or single positions in existing companies, generally non-control. Once it's control, it becomes a buyout.

So what we're doing, and what the market's doing, is providing a liquidity alternative for non-control direct private equity investors. So typical deals-- it could be a financial institution, an insurance company, a bank, a mezz lender that own a portfolio of direct investments and are looking for an exit of that portfolio or specific positions. It could be a GP in an existing fund. They're looking to do a range of things but they could be selling one position or portfolio positions. Or it could be a founder or an early shareholder in a company where they are looking for an exit of their single position. That's generally the different types of assets and transactions in the direct secondary market.

Privcap: What's driving activity in these markets?

Wachter: So the direct secondary market is growing significantly. There are a number of reasons and drivers why existing shareholders are looking for this type of new alternative. They generally fall into three categories. A existing shareholder wants cash, wants to manage reserves, or wants to book some sort of realization, either for tax or book purposes. With regard to cash-driven transactions, there's a huge range of funds today that are short on distributions relative to paid in capital.
In fact, the DPI of the industry for private equity has shrunk considerably. In 2008, a five-year-old fund on average had returned about 80% of contributions. Today, a five-year-old fund has only returned about 25% of contributions. So GPs need to really be more active in how they generate gains for their LPs and drive liquid events, not just unrealized returns. So a lot of GPs are now selling

positions, selling partial positions, or some form of both to really maximize and optimize their realizations.

Another aspect with regard to GPs-- in a typical 10-year fund, it's really difficult to manage exactly how much reserves you need for the existing portfolio, to support the whole portfolio to exit. Because of the lost three years '07, '08, '09, a lot of these funds have mismanaged and misbudgeted exactly how much reserves they need. What direct secondaries allow a GP to do is to sell a part of an existing asset, use those proceeds for recycling, and better optimize the remaining reserves. Use that money for other portfolio companies, to grow those further, for a strategic M&A within the portfolio, or it just basically adds flexibility to a GP's remaining reserves and entire balance sheet when it's so unpredictable how long it takes to exit a portfolio-- again, within that fixed 10-year time frame.
A third motivation for cash and for GPs is, of course, as funds get to later in life. We don't really like the word zombie funds. It's not something that any GP or the LPs feel that they're involved in. What it simply is, is it's funds that are struggling later in life to exit remaining portfolio companies. The direct secondary market is a way that that can be addressed.

Privcap: What challenges do you face in completing these types of deals?

Wachter: When a fund reaches the end of its life, or close to the end of its life, there's a lot of challenges that the GP and the LPs face. There are actually 3,000 funds, both PE and venture funds, that are reaching year 12 of maturity in the next three years. So there's this enormous wave of challenges that both GPs and LPs are facing in how to address the tail end of these funds.
In fact, a lot of discussions that we're having with LPs, they're sharing with us that they get multiple requests every week for fund extensions. The default today is to no longer allow GPs to charge fees, maybe at year 10 but certainly at year 12. And then the question is, what do you do with the remaining portfolio? There's really three options for an LP. An LP can sell their LP interest, an LP can extend a partnership further, or the GP can sell the remaining assets. And that's pretty much it.

Privcap: In today’s market, which scenario is leading to the most deal flow?

Wachter: In terms of selling your LP interest, there is a limited market for that. The challenges are that a secondary LP buyer also recognizes that there's a limited duration, there's misalignment of the LP base, and it's a very challenged time frame for any particular fund, so the discounts are materially more significant than a typical LP secondary deal. When it comes to either extending or selling assets, the question is, is this the right time to optimize the sale of those investments, or do you wait?
What happened in one or two very recent deals is substantial, reputable GPs have reached this end of life. The view by the GP is that these assets should not be sold today. Whether they're control or non-control, that was the GP's view. What they did was find, in fact, replacement LPs. And it's an entire restructuring of the fund.

That can happen, and it has happened. But it will be very, very limited and special circumstances that allow for that to happen. The deal needs to be large enough, the remaining assets need to be attractive enough, and they need to be well diversified. The attractiveness to the buyer is that they mitigate an entire J curve. The negative is that it's generally very low multiple-type opportunities. But if they're shorter duration with zero J curve, there's very late stage institutions and LP secondary buyers that that complements their strategies.

But that's very, very few funds that will fit that criteria properly. The vast majority will eventually need to monetize, in an orderly fashion, the remaining assets. The last and most difficult scenario is actually the GP closing the fund and distributing shares in private company to their LPs. That's disastrous to the GP, it's a problem for the LPs, and it's worst for the underlying portfolio companies, because now they're reporting and their shareholder base is a fragmented base of limited partners, passive investors, as opposed to the single GP that they had a relationship with for 10 years.

Privcap: What are the greatest risks for a direct secondary buyer?

Wachter: There's a couple of risks that are unique to direct secondaries. The one most significant one is alignment of interest with the other shareholders. So the direct secondary investor is coming into an existing deal where there's existing institutional investors that, by definition, have been investors for multiple years.

If the existing shareholders and the buyer don't have similar expectations for the company, similar reserves, similar time frame to an exit, then you have a significant misalignment of interest. Now, before a secondary investor comes in, by definition there is a misalignment of interest among the existing shareholders, because somebody is looking for an exit and the others aren't. If they were all aligned, they would either all be looking for an exit or all be seeking further growth and optimizing an exit at a later date. So what a buyer has to really watch out for and be comfortable with is that they're time frame is reasonably consistent with the other shareholders.