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Secondary Market Overhang Not Solely Due To 'Discount'

By David Wachter of W Capital Partners

The secondaries market has grown remarkably over the past few years, becoming a significant area of interest for LPs as well as GPs. There is approximately $30 billion in committed capital currently available for limited partnership interests and $2 billion available for direct investment secondary purchases. While the amounts are significant, there has been more than $1 trillion committed to private equity over the past ten years, making the sums in the secondary market appear modest. Recent estimates suggest that as much as $200 billion of private equity commitments will be sold in the secondary market over the next two years.

On the surface, the current market environment would appear ripe for record volumes of secondary transactions. LPs need relief from unfunded commitments and GPs require access to capital to make follow-on investments in existing portfolio companies. If both LPs and GPs face enormous market pressure for liquidity, then why has the secondary market transacted on the relatively limited volume of approximately $10 billion to $15 billion over the past year? While there is a large supply of secondary opportunities available, demand remains relatively constrained. This imbalance can be attributed to the following factors specific to the secondary market:

Valuations Private equity and venture capital valuations, despite FAS 157, have declined considerably less than the public market has over the past year. At year-end 2008, private equity investments were generally marked down approximately 25% to 30%, compared to 40% declines in the S&P 500. Given the significantly higher leverage in buyouts relative to public comparables and the substantial financing risk today in venture capital, one would expect that declines in reported private equity valuations would be more severe then those seen in the public markets. In fact, GPs are carrying many of their private investments at implied multiples above their public equity comparables. Are the public markets undervalued or are private valuations excessive?

Secondary transactions are being completed at values well below reported NAV, suggesting that buyers are applying current market multiples. In the direct secondary market, valuation is based upon comparables, underlying portfolio company financial performance and exit expectations, all of which are currently in flux. This gap in the bid/ask spread in secondary transactions will close over time as GPs continue to apply mark-to-market accounting and the public markets normalize. However, there are additional factors adding complexity to secondary market transactions.

Transparency Secondary market transactions are largely based on second-hand due diligence. Sellers must work with buyers to convey sufficient diligence information and provide direct access to investments to satisfy buyers' underwriting criteria. Under normal market conditions, financial statements, budgets and recent business plans provide considerable comfort. In the current environment, few portfolio companies have met expectations over the past six months and few have conviction in their 2009 plan. GPs with complete access to management and the board are themselves challenged to project future company performance. For a secondary buyer, the diligence challenge is an order of magnitude greater resulting in a higher bar on deal selection and more conservative projections, both of which are reflected in total secondary volume.

Capital constraints and co-investor risk Portfolio construction in private equity over the past several years has been based on expected investment hold periods of two to six years, with a steady stream of realizations thereafter. Given the freezing of liquidity and the limitations on LP capital, many GPs are capital constrained and are applying portfolio triage with the limited reserves they have remaining. GP capital constraints are creating enormous pressure for portfolio companies as buyout deals face debt issues and venture-backed companies require capital for growth.

For a secondary buyer of direct investments, there is significant risk in investing where certain shareholders are liquidity constrained and investor syndicates are not substantially aligned. For the secondary buyer of LP interests, a comparable risk occurs within an investment partnership exposed to potential LP defaults. In effect, co-investor risk is a challenge for both primary and secondary investors, but primary investors can structure terms and recapitalize their investments at time of investment. Secondary investors, however, do not generally have that opportunity.

The outlook The secondary market today is a significant provider of liquidity to both LPs and GPs, and the market will certainly grow dramatically over the coming two years. The current focus on discounts will likely diminish within the next several quarters as reported NAV adjusts to market conditions and the atypical market factors discussed above will resolve themselves or alternatively, buyers and sellers will establish appropriate valuations that reflect the current inherent market and company risk. Under either scenario, it is likely that buyer and seller expectations will converge and analyst estimates of secondary market growth will be achieved.

David Wachter is a founding partner and managing director of W Capital Partners, which acquires portfolios of direct private equity and venture capital investments in the secondary market. Wachter has completed over 100 private financings, initial public offerings and merger and acquisition transactions. Prior to W Capital, Wachter held senior roles as an investment banker for 15 years at Lehman Brothers, Jefferies & Co. and C.E. Unterberg.