Take My Venture Fund—Please!

Private equity investors are dumping billions of dollars of mistakes into the secondary market. Some scavengers will get rich.

BY ERIKA BROWN WITH PHYLLIS BERMAN

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A HUNDRED AND FORTY DEALmakers from a dozen cities around the world gathered over dinner at the W Union Square hotel in New York City in March to toast the closing of a $1.8 billion deal. Deutsche Bank had sold its private equity portfolio—all 83 companies—to seven buyers from five countries. The dinner was fittingly modest for the era: chicken, not caviar; California bubbly, not French. Yet it was the largest, most complex deal ever done in the market for cast-off private equity partnerships, and it's just the beginning.

Over the last five years investors have thrown $882 billion of cash at buyout, venture and so-called mezzanine funds. The market bust has soured much of this investment so badly it is beyond any hope of a decent return to the original investors. Many of them want someone to cart the dreck away.

Deutsche Bank's portfolio was in fairly good shape, and it avoided having to sell below book value. "A transaction of this size would have been impossible to imagine five years ago," says George Stamas, lead counsel on the deal and a partner at Kirkland & Ellis. "Now every financial institution in the world seems to be contemplating a deal like this."

Most sellers won't be as joyful. Buyers are demanding discounts of 60% to 75% to net asset value, which already reflects mark-to-market discounts of as much as

75% from the original cost. In sum, many venture capital pools are worth as little as 6 cents on the dollar. Some sellers, who are still on the hook for additional capital calls when the manager of a pool requests, are so desperate they are paying buyers to take over their positions.

How are the scavengers doing? Only a few are ready to boast about their returns. In late 2001 Coller Capital of London purchased 80% of Lucent's venture capital portfolio of 27 companies for $100 million. Six weeks later one of those companies, Celiant, a maker of wireless power amplifiers, was sold to telecom equipment firm Andrew Corp. for $470 million. Lucent's original 40% interest meant the one sale yielded Coller almost twice its initial investment, and Coller still holds stakes in 25 more firms.

Word of deals like this one has enabled the vultures to raise more money for investment pools of their own. Coller Capital raised a $2.5 billion fund last October. Goldman Sachs is on its second secondary fund, GS Vintage Fund II, with $1.1 billion in its coffers. Lexington Partners is closing on a $2 billion fund this month. Credit Suisse First Boston raised an $832 million fund in 2001.

But the amount of capital raised since 1998 by secondary buyers—$13 billion, according to Thomson Financial Venture Economics—is a little less than half of what will likely come up for sale this year. A lot of sellers, including commercial banks, pension funds and wealthy individuals, will be left holding the bag. Commercial banks will be desperate to offload the biggest portfolios now that new global regulations require them to increase the reserve against private equity holdings from 8% of the portfolio value to as much as 25%. Banks would much rather lend cash than use it to guarantee sorry deals. The rule change could free up some $20 billion in equity deals, according to HarbourVest, which has a secondary fund with $3 billion to invest.

Some pension funds and endowments are selling to readjust their assets, as the stock market decline has caused their private equity holdings to jump to 15% to 25% of their portfolios, when 5% to 10% is the usual allocation. Corporations are eager to sell if they need the cash or a writeoff. In March plastic film maker Tredegar Corp. took $75 million for limited partnerships and direct venture investments once valued at more than $300 million. GS Vintage Fund II picked up the tab and enlisted W Capital Partners to help run the portfolio. Tredegar got a $55 million tax recovery and relief from obligations to chip in more money.

Many high-tech executives who bought into venture capital with gusto during the boom can't afford to meet capital calls now. One insider says some 400 individuals are looking for bailouts. Better to sell at a discount than to default. "You can forfeit your partnership interest and still be on the hook for your entire capital commitment," says Jonathan Axelrad, a partner at Wilson, Sonsini, Goodrich & Rosati in Palo Alto, Calif. At New Enterprise Associates limited partners would get dinged half their stake for each default.

▶ By the Numbers

Buyer's Market

With twice as much for sale as there are dollars to spend, brave souls can get $1 for a handful of pennies.

$882 billion
Private equity raised since 1998.

$26.4 billion
Potential amount of secondary deals up for sale.

$13 billion
Secondary funds raised since 1998.

6 cents
What a $1 interest in a year 2000 venture fund might bring today.

Sources: Thomson Financial Venture Economics; HarbourVest.

Last year Landmark Partners scored ten "walkaway" deals in which it paid the original investor nothing for his position and agreed to cover future capital calls. Begg at HarbourVest closed on two walkaways in January. He also landed two deals where he was paid to take the commitment off the seller's hands.

The buyers are picky. Venture Capital Funds of America reviewed $4.5 billion worth of venture stakes last year yet bought only $20 million. "In the early 1990s secondary buyers could make money by buying any fund at a 30% discount," says managing director Brett Byers. "But there are some funds you don't want to buy at all now. You can get seriously burned, even at a discount."

Portfolios with dozens of early-stage firms are devilishly hard to value, so most secondary buyers lower their risk by getting in at the fourth or fifth year of a fund, when there's less investing to do and payouts from public offerings start to kick in. They also save a few years of management fees. "Even after you figure in the discounts, you have to be sure the fund you're buying has enough capital to do follow-on investments in its portfolio companies," says Jerrold Newman, who manages $100 million in secondary funds at Willowridge in New York. Otherwise, he warns, "the fund could get washed out and your investment could be written down further."

Goldman, Paul Capital Partners and VCFA are all structuring deals to limit risk. One device, called a profit share, allows a seller who thinks he deserves more than the offer price to share in future profits, but only after the buyer has taken up to three times his original investment. Still, terms can't protect anyone from making a bad bet. Jay Pierrepont at Pantheon Ventures is putting 80% of his money into buyout, rather than venture. He thinks many 1999 and 2000 venture funds are a losing proposition at any price: "Venture funds are in the valley of death—and no one knows for how long." **F**

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