

WHITE PAPER NO. 45

SECONDARY INVESTING
IN PRIVATE EQUITY

GREYCOURT

White Paper No. 45 – *A Brief Primer on Secondary Investing in Private Equity*

Much has been written recently about secondary purchases of private equity in today's turbulent market and the heightened interest among investors as both sellers and buyers. This paper will examine some of the key elements of secondary investing and of investing with secondary fund managers, and will provide a framework for evaluating secondary managers.

Secondary Investing

Secondary investing in private equity can take many forms and strategies. The sub-sector itself is relatively small, becoming "institutional" in the 1980s and gaining real traction in the early 1990s as several large institutional investors in private equity exited the business via secondary sales. The level of interest in secondary investing ebbs and flows with the state of the markets. Today, interest is at an all-time high. This is the result of several factors playing out simultaneously: the "denominator effect," where declining public equity markets cause commitments to private equity to exceed their strategic target levels under an investor's investment policy; liquidity issues with individuals or institutions who no longer can, or no longer wish to, meet capital calls; rapidly declining valuations driving investors to cut their losses; and/or emotional exhaustion leading to capitulation.

The last very active period for secondary investing was earlier in the decade. Initially, when the 2000 "bubble" burst, secondaries fed off of over-committed investors, mainly individuals. A few years later, banks began wholesale exits due to "strategy changes" and newly-imposed capital requirements on private equity investments. Secondary investing interest trailed off in 2005-07 as PE investing over-heated. High levels of distributions required increased commitments to maintain policy weightings, and this problem was exacerbated by surging long equity markets. Today, interest in secondary investing is probably at an all-time high, and for good secondary funds it has become a buyer's market.

Secondary Funds

For all the interest in secondaries today, it remains a very small part of total private equity. For the last several years secondary funds have represented about 3% of US and about 2% of worldwide private equity. For 2007 and 2008 this translates into roughly \$45 billion in secondary funds under management. By one estimate, the extraordinary interest in

secondary transactions today has created a significant gap between the supply of interests for sale versus the demand to acquire – something on the order of 2:1. As a result, secondary pricing as a percent of underlying investment NAV has collapsed. During the period 2005-2007 secondary buyers were paying over 100% of NAVs. Today, discounts from NAV range from 50-80% *if you can find a buyer*. This supply/demand imbalance is further complicated by the uncertain year-end revaluations that will be generated by the application of FAS 157.¹

Secondary strategies

Secondary funds can take different forms. There are the stand-alone, narrowly focused secondary funds that do nothing but acquire secondary interests in private equity (either or both venture capital and buyout). As we will see, their strategies for acquisition can vary. There are also primary funds that have the authority under their limited partnership agreements to make secondary purchases. Many funds of funds fall into this category.

Size Matters

Independent secondary funds fall into one of two broad categories: very large and “smaller.” Very large, multi-billion dollar funds have a great deal of capital to put to work in a fixed period of time and as a result will generally pursue larger transactions. Investments of \$50 million and greater most often involve an auction and pricing can come under pressure. Smaller funds tend to pursue transactions where less competition exists and where the pricing is likely to hold up better. In some of these cases, the seller may have a special relationship with the secondary fund and may wish the transaction to remain out of the public eye.

Strategy

The classic strategy for acquiring a private equity interest through a secondary transaction is for the acquirer to purchase a limited partner’s interest in a fund or fund of funds. Generally speaking, limited partner agreements stipulate that partners may not transfer their interests or commitments. To effect a transfer requires the approval of the general partner, who will normally take control of the process in an effort to assure that the outcome does not damage or jeopardize other LPs or the fund. Variations on this theme include purchasing the entire LP interests of a fund that is in its last year’s of existence, purchasing portfolio company interests directly out of funds, purchasing misguided PE investments from hedge funds, and so on.

¹ See the appended note about the impact of FAS 157.

Maturity

The maturity of the private equity interest to be acquired via a secondary sale is a key determinant to establishing the price a potential purchaser is willing to offer. If the private equity interest is fairly mature, say in the 6th to 8th year of its life, more will be known about the underlying investments made than in a fund that is only 2 to 3 years old. In the latter case not all of the investments will have been made and those that have been may be too early in their lives to assign a value with any degree of confidence. This level of uncertainty, along with the uncertainty associated with investments yet to be made, will cause a potential purchaser to increase the discount required to purchase a secondary interest in a newer fund. In the hypothetical case of a 7 year old fund that has completed its investment period, all of the portfolio companies are in place. Of those, a certain number will not succeed (or will already have failed), and the remaining companies can be analyzed separately and values assigned. All of this will be subject to some discount rate and the pricing will then be determined. This cannot be done with, say, a 2 year old fund that is continuing to identify investment opportunities, and where the greater level of uncertainty will drive much bigger discounts.

In the current environment some institutions and individuals have concluded that they are over-committed to PE. To the extent that they have older investments the least economically painful path may be to sell those. This does not, however, address the issue of continuing capital calls on newer commitments, should they also have those in the portfolio. Actions undertaken in the secondary market to address over-commitments will vary from entity to entity depending on individual circumstances, but broadly speaking, the secondary market is less interested in newer commitments. These are often best sold to another limited partner in the fund versus the independent secondary market.

Important Considerations in Selecting Secondary Funds

With that high level overview in mind, let's look at important considerations in selecting secondary fund managers. In every case, we look for a level of independence in the manager. This is to ensure that there are no conflicts of interest and that pricing will be absolutely savage. Here are some key points to keep in mind:

Management

Secondary investing is very similar to direct investing in that the price paid for an interest is based on a perception of the value of underlying investments within the partnership interest. As a result, managers of secondary funds must have extensive databases that permit them to model out the potential value of each underlying investment. Similarly, they must have the experience and skill to do this. Track records are essential.

Access

Deal sourcing is an important consideration. Often, relationships with GPs will provide access to transactions without a lot of competition. The reputation of the secondary fund manager for timely evaluation, discretion and execution can be key to driving opportunities.

Strategy

There is no one strategy that is superior to another. But it is important to understand the strategy in order to determine if the manager has the skills and experience to execute it, as well as to consider the potential nature of the returns.

Terms

All of the terms and conditions that are relevant to evaluating any private equity manager are applicable here. Fees are a bit of a departure, however. This secondary business is closer to direct investing than to fund investing, and as a result the fees reflect it. Management fees range from 1.50 - 2.00% with carried interests up to 15%.

Performance

A history of successful returns is essential. First time secondaries are to be avoided.

Conclusion

Secondary investing has been a factor in private equity continuously for several decades. Demand for the art ebbs and flows and seasoned managers make adjustments accordingly. Today an unusual supply of less mature partnership interests exists and managers are responding. We expect the next three to four years to result in record secondary transaction volume.

A Note About the Impact of FAS 157

Investors have been anxiously awaiting year-end 2008 private equity valuations, since this is the first year that application of Financial Accounting Standard Rule No. 157 (“FAS 157”) is mandatory. This rule is intended to provide a consistent framework for fairly valuing investments. Fair value is not a new concept, but consistent application of the fair-value principle to private investments is, at best, tricky. FAS 157 employs the concept of “exit price” determined in an “orderly” manner and establishes a hierarchy of inputs to use in fair value measurement:

- Level 1 – Prices observed in active markets
- Level 2 – “Other observable inputs”
- Level 3 – “Unobservable inputs”

Since the vast majority of private equity investments do not trade in the active markets, Level 3 is most commonly applied. (Level 2 would apply to identical assets in thinly traded markets, but this factor is not applicable to most private investments.) In the case of Level 3, fair value is determined through an analysis of EBITDA multiples, estimation of discounted cash flows, a review of individual financial statements, and/or an analysis of comparable public securities. Accounting firms and even individual accountants within the same firm do not agree on consistent application of these metrics and that is creating controversy and uncertainty. Valuations of very large private investments (i.e., companies with considerable debt where public market comparables have fallen sharply and debt repayment is uncertain) create the greatest opportunity for inconsistent valuations. There is less controversy with smaller investments or where little or no debt is involved. Investors argue, however, that all of this has the potential to ignore the intrinsic value of long term assets and to create artificial volatility in pricing. In any event, valuations of private investments have suffered from the crisis in our public equity and credit markets.

GREYCOURT & CO., INC.

March 2009

(This paper was written by David Lovejoy, CCO, CFO & Managing Director of Greycourt & Co., Inc. The author can be reached at dlovejoy@greycourt.com, www.Greycourt.com.)

Please note that this presentation is intended to provide interested persons with an insight on the capital markets and is not intended to promote any manager or firm, nor does it intend to advertise their performance. All opinions expressed are those of Greycourt & Co., Inc. The information in this report is not intended to address the needs of any particular investor.