GREYCOURT

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Secondary Investing in Private Equity

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Secondary investments in private equity can be an attractive addition to primary private equity investments. They offer broad diversification across vintage years, industries, geographies, managers and investment strategies. Generally, capital is deployed faster than with primary commitments, reducing the time that commitments are held in reserve, and they have shorter life cycles than primary funds. Realizations usually occur more quickly, driven by the maturity of the interests acquired. This has the benefit of minimizing the impact of the J-curve. 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

The secondary market for private equity investments bears a direct relationship to the size of the primary private equity market. Historically, growth of the secondary market mirrors growth in the primary market with a few years lag. In the early 2000's, following the record fundraising of immediately preceding years and a bursting of the bubble, the secondary market became very active, mainly addressing the liquidity needs of over-extended investors. More recently, with the significant amounts of capital raised in 2005-8 it is not surprising that during 2010-11 activity in the secondary market was at an all-time high. Globally, primary private equity commitments have grown dramatically since 1990. Cumulative commitments since then now exceed $4 trillion. It follows that the secondary investing market will continue to grow.

In the early years of the secondary market, most transactions were driven by individual investor needs, mostly an unanticipated need for liquidity. Today there is a wider range of factors at play such as: new regulation requiring financial institutions to reduce private equity exposure, investors proactively rebalancing investment portfolios in order to manage volatility, consolidating manager exposures and exiting aging investments with little remaining upside but bearing administrative costs. As the secondary market has grown, so have the number of participants and the diversity of techniques and strategies.

❖ Secondary Funds

Historically, secondary sales were estimated to represent 3-5% of all primary commitments. As selling into the secondary market has become more widely accepted as a portfolio management tool, that level grew to approximately 6% in 2011 and is estimated to rise to 9% over the next two to three years. Secondary funds attracted a great deal of attention following the credit break in 2008. At that time many investors, including some high profile endowments, found their allocation to private

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equity had surged to well above their desired targets and this, along with other liquidity pressures, created an atmosphere of large panic secondary sales. During the peak of the panic, discount pricing to NAVs became dramatic but in reality very few transactions occurred at these wide panic-driven discounts. However, following these events considerable interest was paid to the secondary sector and fundraising rose significantly.

Today, dedicated secondary funds fall into one of two categories. First, there are the very large, or 'mega' funds of multiple billions of dollars. These funds have a great deal of money to put to work over a relatively short period of years and therefore pursue very large transactions. In most cases, these highly visible transactions involve an auction of the assets. At the other end of the spectrum are smaller, more focused funds. These smaller secondary funds often target smaller sellers of private equity interests. Focusing here can be beneficial as these small sellers often engage in less structured and less competitive sales allowing the small secondary fund more time to conduct extensive due diligence and uncover the best opportunities. Large blocks of secondary sales ($50 million and greater) are often widely marketed and heavily bid. As a result, 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.

❖ Secondary Strategies

Secondary funds pursue different investment strategies. 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 possess the authority under their limited partnership agreements to engage in secondary purchases. Many private equity funds of funds fall into this category. Another strategic differentiator is the target maturity of the limited partner (LP) interests. By and large the secondary market focuses on fund interests that are past their investment period. Another key advantage critical to successful secondary fund investing is 'deal sourcing'. Since the general partner (GP) of a primary fund maintains absolute control over any LP's ability to sell its interest, a secondary fund's ability to establish and maintain good relationships with GPs can be critical in gaining access to secondary opportunities. Better quality secondary fund managers work hard at developing these relationships and are known for their specific strategy, i.e. maturity sweet spot, sector or style specialization. Getting the 'first call' from a primary fund GP is a strategic advantage earned over time. For the mega funds, just being known to have the capital to execute a major transaction creates a certain advantage with the larger deals.

The age of the private equity interest to be acquired via secondary sale is a key determinant in establishing the price a potential purchaser is willing to offer. If the private equity interest is fairly mature, say in the sixth to eighth year of its life, most of the fund's capital will have been deployed and therefore more will be known about the underlying investments than say in a younger fund that is only two to three years old. In the latter case, few investments will have been made and those that do exist may be too early in their lives to enable a value to be assigned 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.

❖ Important Considerations in Selecting Secondary Funds

With the aforementioned high level overview in mind, let's look at important considerations in selecting secondary fund managers.

At Greycourt, we look for a high degree of independence in the secondary manager. This is to ensure that minimal conflicts of interest exist and that pricing will strictly seek to maximize investor returns. Here are some key points to consider:

Management

Secondary investing is similar to direct investing in that the price paid for an LP interest is based on assessment of the value of underlying investments held within the partnership interest being acquired. As a result, managers of secondary funds must maintain extensive databases enabling 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. Good relationships with GPs provide access to transactions without a lot of competition. The reputation of the secondary fund manager for timely evaluation, discretion and efficient execution can be key to driving opportunities.

Strategy

There is no one particular secondary strategy that is superior to another. It is important, however, to fully understand each secondary manager's strategy in order to determine if they have the skills required and experience necessary to execute it, one must also evaluate the potential magnitude of the returns.

Terms

All of the terms and conditions that are relevant to evaluating any private equity fund are applicable here. Fees can be a bit of a departure, however. This secondary business is closer to direct private equity funds than to funds of funds. As a result, management fees can range from 1.00 - 2.00% with carried interests up to 15%.

Performance

A demonstrated track record of successful returns is essential. First time secondary funds are generally to be avoided unless the manager has a history in private equity that creates a compelling story. Such circumstances might include an experienced primary fund manager with a positive direct investing track record that leverages his or her knowledge and GP relationships into the secondary market.

❖ Conclusion

Secondary investing has been a factor in private equity continuously for several decades. Like anything else, the opportunity set for these types of investment ebbs and flows and seasoned managers must make adjustments accordingly. As we enter 2013, there appears to be a healthy balance between supply and demand in the secondary market even though fundraising has grown considerably.

❖ A Note About the Impact of FAS 157

Financial Accounting Standard Rule No. 157 ("FAS 157") was implemented in 2008. 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 often do not agree on consistent application of these metrics and that has created controversy and uncertainty. However, with the passage of time the implementation of this rule has become less of an issue. 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. For the secondary buyer, accurate NAVs are important.

This paper was written by David Lovejoy, Managing Director of Greycourt & Co, Inc. Mr. Lovejoy can be reached by phone at 412.361.0100 or by email at dlovejoy@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.