

Secondary market in private equity

September 2009

Introduction

As the recent market crisis has unfolded, one area of the private equity landscape that commentators suggested would inadvertently benefit from the market conditions was secondary funds and their limited partners (LPs). The reality to date appears to have been somewhat different, with very few transactions clearing the market (at the time of writing) due to a continued dislocation between buyers' and sellers' pricing expectations. The purpose of this paper is to explore this dynamic and consider the prospects of the secondary market moving forward.

Why secondaries?

Before we consider the current market conditions in closer detail, let us first remind ourselves of the rationale for investing in secondary funds.

Investors in secondaries can expect similar benefits to investors in traditional private equity funds including returns that are potentially superior relative to quoted markets. In addition, secondary funds offer the potential to acquire high quality assets at discounts to net asset value (NAV), benefit from mitigating the 'J-curve' due to buying mature portfolios with a more rapid cash-flow pattern than a traditional private equity fund and can provide investors with immediate vintage year diversification.

So what happened?

In late 2008, amid the market turmoil following the Lehman Brothers' bankruptcy, estimates of available secondary purchasing capacity were in the region of US\$40 billion, whilst estimates of the potential supply of opportunities from sellers were in the region of US\$140 billion¹. The reported supply of opportunities soared as LPs grappled desperately for much needed liquidity and looked to deal with the 'denominator effect', whereby the crash in equity markets forced their private equity exposure rapidly above their target allocations in percentage terms. This has impacted a large proportion of investors with over 60 per cent of LPs surveyed by Probitas Partners conceding to being at or above their target allocation to the asset class². Consequently, the widely

1 Pantheon, Take Note: Secondaries, April 2009

2 Probitas Partners, Second Thoughts Newsletter, Volume 1, Number 1, July 2009

accepted expectation was that this supply-demand imbalance would allow buyers to dictate prices amid a period of significant deal activity in the secondary market. However, as explained below, this expectation has not been borne out in reality. Actual deal activity between the fourth quarter of 2008 and the present (September 2009) has lagged these expectations significantly for three main reasons:

1. **Buyer-seller dislocation:** pricing expectations between buyers and sellers remain very different, thus only the deals with the most motivated sellers have completed. Buyers are cautious given the uncertainty surrounding expected future operational performance of underlying portfolio companies and the validity of general partner (GP) valuations. As such, bids made in the first half of 2009 saw 60-80 per cent discounts to fourth quarter 2008 NAVs for many buyout funds, emphasising that only the most desperate sellers would transact.
2. **LP liquidity crisis (temporarily?) abated:** the number of sellers forced to accept any price offered for their positions due to an intense liquidity need has been lower than expected. This is thanks to the lack of capital calls from GPs (reducing the need for available capital) and the rebound in equity markets (reducing the impact of the 'denominator effect').
3. **Significant divergence between available assets from sellers and buyer preferences:** much of the estimated supply of opportunities from sellers are 2006-2007 vintage mega buyout funds (often

largely unfunded positions) as LPs looked to selectively reduce their unfunded liability in out-of-favour strategies in order to allow them to make fresh commitments to 2009-2010 vintage funds. However, the aforementioned Probitas Partners' survey concluded that buyers in the secondary market are most interested in mid-cap buyout and growth strategies and are particularly averse to mega buyout funds. This is either due to concerns about the underlying assets being over-valued and over-levered during the boom period, or where the funds remain only partially drawn down thus there are relatively few assets for secondary buyers to value.

Watson Wyatt's view and outlook

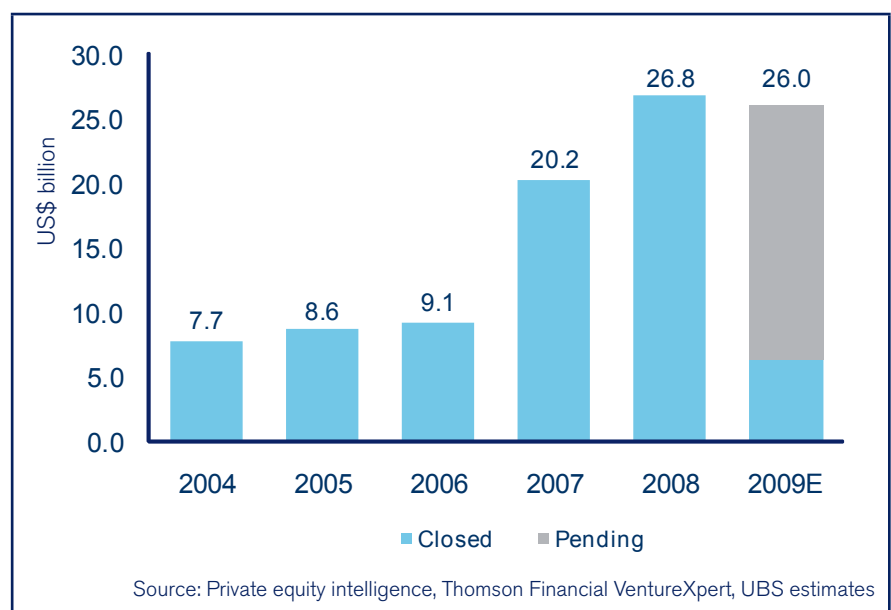
The widespread excitement about secondaries appears, on the face of it, to share some similar characteristics with recent periods of over-exuberance in other areas of the private equity market. Similar to the mega buyout frenzy in 2005-7,

we are always cautious about the widely recognised 'strategy du jour'.

So why were we (and why do we remain) relatively cautious about investing in secondaries?

The headline estimated levels of supply of opportunities do not tell the full story as many sellers do not **have to** sell. As such, they have held on to their positions as option value, and they might choose to continue to do so if they do not face significant liquidity problems. In addition, the headline level of demand is actually understated due to the emergence of new buyers into the market attracted by potentially outsized returns. There is a lot of capital chasing secondary opportunities at the moment (see Figure 1 showing dedicated secondary funds raised in recent years). A recent report published by Cogent Partners emphasised this, noting that over 50 per cent of the bids received in the first half of 2009 were from "non-traditional secondary buyers"³. The combination of these factors reduces the perceived supply and demand

Figure 1 | Secondary funds raised



3 Cogent Partners, Secondary pricing analysis, Interim update, Summer 2009

dislocation between buyers and sellers which secondary managers and intermediaries have been advertising for some time.

Probitas Partners' survey also highlights that the dislocation between buyers' and sellers' pricing expectations continues to prevent deal activity with 70 per cent of sellers noting they would refuse to accept a discount over 40 per cent of NAV, whilst 75 per cent of buyers are only interested in buying portfolios with discounts in excess of 40 per cent. It remains to be seen exactly how this situation will evolve, but it appears that both parties must move from their current pricing positions if deal activity is to increase significantly.

An additional challenge for potential investors in secondary funds to overcome is the high fees that are charged by secondary managers. Fees charged in the investment period are typically high at 1.0-1.5 per cent on committed capital. However, some managers continue to charge on committed capital throughout the life of the vehicle which leads to a substantial fee drag in the latter years of a vehicle's life. Figure 2 emphasises this, with the fees charged by secondary managers significantly outweighing the fees charged by the underlying managers in the latter years of a secondary fund's life. Given the responsibility lay with the direct manager to actively own the business and manage the exit process, this represents an inappropriate drag on fees for the secondary fund investor.

As with other strategies in private equity and indeed broader illiquid alternatives, given the scarcity of capital and challenging fund-raising environment, we fully expect

investors to be able to secure a fairer deal on fees with secondary managers raising over the next 12-24 months.

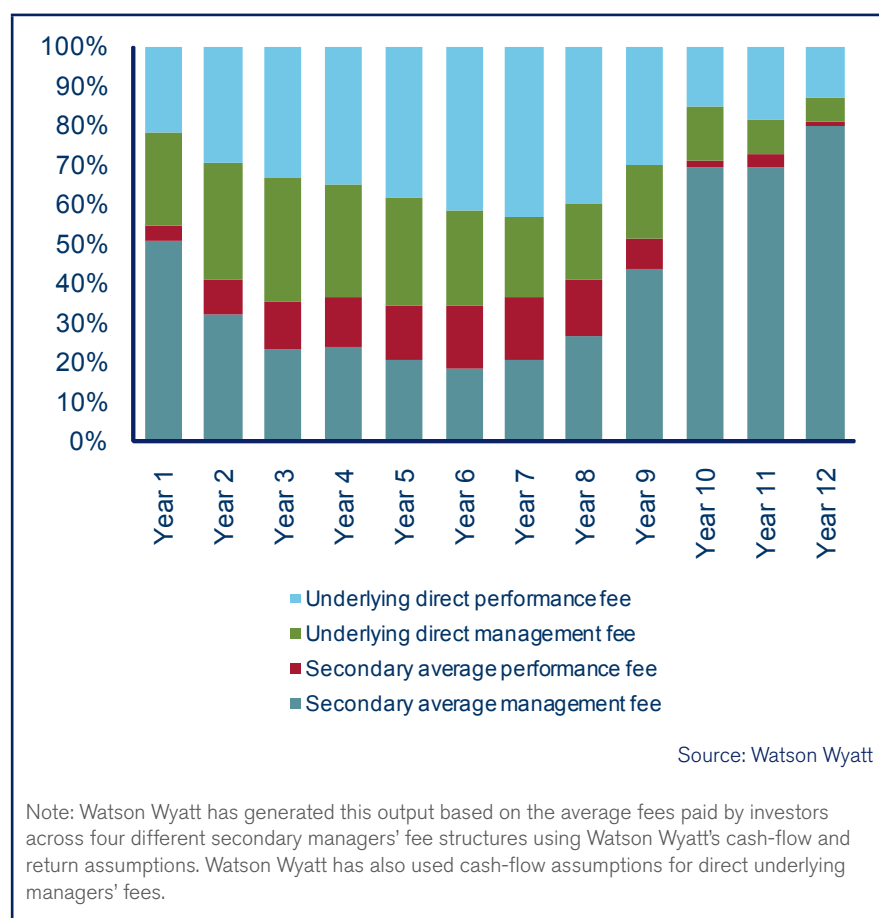
So how do we expect the market to evolve?

If liquidity concerns do not manifest themselves into genuinely forced sales in the near term, buyers (many of whom have raised large dedicated vehicles in anticipation of a wave of deal activity that has not yet come to fruition) will be forced to increase bids to deploy their capital in order to meet sellers' expectations. There is evidence of this from Cogent Partners' report referenced above which concludes that pricing for secondary positions strengthened over the first half of 2009. This, combined with increasing demand

potentially competing away some of the value on acquisition, emphasises that the attractiveness of the 'beta' in secondary investing is far from clear cut.

Broadly speaking, some level of stability in the broader economy and therefore more transparency on the operating performance of underlying portfolio companies is likely to be necessary for increased deal activity to occur. We think it is reasonable to expect this to happen during the course of 2010. Some level of economic stability is also likely to lead to increased activity in the primary market, which we expect to have a knock-on effect on the secondary market as capital calls crystallise potential liquidity issues at some struggling LPs.

Figure 2 | Distribution of fees paid by an investor in a secondary fund between underlying manager and secondary manager



We also anticipate an increase in the trend of buyers forcing sellers to slice up their portfolios to allow the acquirers to be selective over which positions they take on. It is during this process that secondary managers will be able to earn their fees as selectivity will be vital in dictating future secondary fund performance.

Given the increasing number of reasons for secondary sales (for example, short-term liquidity, relief from future calls, risk reduction, portfolio management, optionality and so on), we also predict an increasing volume of structured transactions. This trend will allow high quality secondary managers to differentiate from peers via their strength of relationships and their ability to negotiate a deal that is mutually attractive from both buyer and seller perspectives.

So why would I think about making a commitment?

Despite much of the above caution, we do believe there is a case for considering a commitment to a secondaries manager. The traditional reasons for investing in secondary funds remain robust – namely more rapid deployment of capital than primary funds mitigating the impact of the ‘J-curve’ and vintage year diversification. These are particularly attractive characteristics for new investors in the asset class.

Additionally, as suggested above, when markets normalise, there is likely to be increased activity in the secondaries market. There has been exponential growth in the primary market in recent years and we expect this growth to filter through to the secondaries market over time. As such, there will be an increase in buying opportunities over the medium term.

In the short term, the market dislocation will undoubtedly create attractive opportunities for disciplined secondary managers who have intimate knowledge of underlying portfolios and are able to selectively identify attractive positions within sellers’ portfolios. In addition, those managers with differentiated relationships within the LP community and strong negotiation skills will be able to structure attractive deals going forward.

In short, with some positive tailwinds working in their favour, we believe that a small number of highly selective, disciplined secondary players are well positioned to generate outsized returns in the current environment.

Watson Wyatt Investment Consulting

No action should be taken on the basis of any article without seeking specific advice. If you would like to discuss any of the areas covered in more detail, please contact your usual Watson Wyatt consultant, or

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