SECONDARIES II

Meet the sellers

In today's secondaries market, many different sellers have many different motivations. By David Snow.

Secondary buyers are a competitive bunch, and they take pains to disagree with each other on the best way to approach the task of investing in partially funded private equity partnership interests. But in today's market, there is one thing they all agree on – deal flow has taken on tidal-wave proportions.

Lambert: purge not finished

In any kind of market, limited partners will have a multiplicity of reasons for getting out of fund commitments. Today, the reasons to sell are both greater in number and more urgent in nature. One obvious factor is that the chaos in the credit markets has forced many institutions to pursue hasty break-ups within their private equity portfolios. "This has been the summer of discontent," says Brent Nicklas, managing partner at New York-based secondaries giant Lexington Partners, describing the general financial miasma that has led to a distinct up-tick in his firm's investment opportunities.

Importantly, institutional investors are today more comfortable taking the secondaries market route to liquidity, thanks in part to years of emphatic education from professional secondary buyers and agents.

Secondary buyers certainly are not discontent, but the robust deal flow has meant long hours and cancelled weekend plans over the summer. Richard Lichter, managing director at Stamford, Connecticut-based secondaries firm Newbury Partners, says his firm keeps careful records of its price offers, or bids, for secondary partnership interests. A year ago his firm was submitting roughly one price offer per week. Now it is submitting roughly three offers per week. "We had our final close in March," says Lichter of his firm's most recent $702 million (€453 million) fund. "At this pace we're going to have to be back in the market later next year" with a new fundraising, he adds.

Who are these motivated sellers that have ruined the leisurely summer plans of so many? They can be divided into roughly three categories: sellers for whom "everything must go" in search of liquidity; sellers seeking refuge from capital calls in the face of slowing distributions and a weak stock market; and sellers who are seeking to pare back the GPs they deal with.

THE "EVERYTHING-MUST-GOERS"

Even grizzled veterans of Wall Street have been shocked to witness the scope and severity of the current financial conflagration, which (hopefully) reached its shock-and-awe climax over the summer of 2008.

Hardest hit have been the bulge-bracket bank holding companies, many of which are "selling anything", according to one secondaries market participant, with "private equity at the top of the list".

One secondaries buyer notes that banks generally have always been

"Some LPs, such as family offices and smaller financial institutions, think they simply have too much private equity. They bought in at a time when there were a lot of distributions and they were thinking that the new fund interests would be funded by the old fund interests."

frequent participants in the private equity secondaries market, and that the sub-prime fiasco is not the first time they have encountered pressure to sell. For example, suggested international banking regulations published in 2004, called Basel II, have for several years served as an impetus for banks to cut back on their private equity fund holdings, seeking to increase their tier 1 capital. However, banks now have increased as a proportion of the total sellers that Newbury is coming across, says Lichter. In many cases, these sellers are requesting maximum speed and minimum publicity. "Many are getting word from higher up that they need to free up this much capital by this date," he says.

Harvey Lambert, a managing director and head of the secondaries group of AIG Investments, says he has been interested to see that even smaller, regional US banks are stepping forward with fund interests to sell. "I'm surprised at how much private equity they actually have," says Lambert. "I thought we had been through this purge already with the banks trying to reduce their exposures as a result of Basel II. That clearly is not the case, given the deal flow."

Lexington's Nicklas notes, however, that the secondary assets to have come out of banks so far may be merely a preview of even greater selling to come. Banks have been far more concentrated on troubled loan portfolios. "Their problems have been so severe that the only way they can get back in line is to shrink their balance sheets," says Nicklas. "And their initial reaction has been to sell $20 billion or $30 billion of loans. Selling $1 billion in private equity doesn't solve the problem."

Nicklas adds: "But now [banks] are getting around to private equity. You're going to see banks go down the balance sheets to look to find smaller pockets of liquidity."

THE CAP-CALL REFUGEES

Lexington, among the most tenured participants in the secondaries market, years ago undertook a study to identify the most critical factors that lead to an increase in secondary activity. The factor with the greatest correlation to an increase in secondaries deal flow was not the stock market, not interest rates, not gross national product, but private equity distributions. "It makes intuitive sense," says Nicklas. "If you're getting a steady stream of distributions, you're getting self-liquidation and reinvesting the proceeds into successor funds. But when that stops, you still have capital calls, which can lead people to feel over-committed, which leads to secondary sales."

As any LP can testify, distributions from the private equity portfolio have indeed dried up, and many investors are seeking to sell off some partnership interests in order to commit fresh capital to favoured managers and honour capital calls through the dry spell.

Says Lichter: "Some LPs, such as family offices and smaller financial institutions, think they simply have too much private equity. They bought in at a time when there were a lot of distributions and they were thinking that the new fund interests would be funded by the old fund interests."

Lichter notes that capital calls without distributions gives some LPs a keen sense of the cost of holding private equity in the portfolio. Bob Long, president of listed fund of funds firm Conversus Asset Management, notes: "Mature portfolios have continued to generate positive cash flow, while less seasoned portfolios have, or will soon, go cash flow negative. Those investors holding younger portfolios will be a major contributor to secondary market supply in 2008 and 2009."

THE CONSOLIDATORS

For many "fiduciary LPs" – limited partners investing on behalf of beneficiaries, such as pension funds and endowments – the slowdown in distributions, exacerbated by the shrunken stock market denominator, has placed an exclamation point against an existing programme of paring back GP names in the portfolio. Groups like the California Public Employees' Retirement System have embarked on a campaign to commit more money with fewer GPs, which means not re-upping with less favoured GPs and, in some cases, selling off many fund interests in the secondaries market.

One secondaries buyer describes these fiduciary-driven sales as more "sensitive" than other types of sales, in part because it often means the GP in question is permanently losing a source of funding (see "To staple or not to staple" p.78).

But in the secondaries market, at the right valuation, a seller's unwanted GP can be a buyer's treasure. From the excitement in the voices of secondary buyers, it is evident that there remains much treasure to uncover. ■