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SECONDARY OUTLOOK IMPROVES WITH MARKET UPTURN

By Joanna Glasner

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Last year, scores of limited partners attempted to sell large private equity stakes on the secondary market, but pulled offerings after bids came in too low for their tastes. In retrospect, they made the right choice.

First-quarter data indicates that secondary prices have rebounded from the lows of 2009. Valuations are up, fueled by a multi-quarter recovery in public markets. And buyers, on average, are accepting lower discounts to reported net asset value, or NAV, on private equity assets.

"People are more optimistic about successful exit events," says **Laurence Allen**, managing member at NYPPEX, a secondary market-maker. He predicts that secondary sales volumes will be double, and possibly triple from last year, when some $12.3 billion worth of interests changed hands. And given that bid-ask spreads have narrowed compared to last year, it's more likely that stakes that come to market will culminate in a sale.

Certainly first-quarter data points in that direction. Bids during the quarter for private equity stakes reached an average of 58.4 percent of NAV, up from 56.4 percent in the prior quarter, according to NYPPEX.

To be sure, predictions for a broad secondary market recovery, for the moment, remain just that. Just as forecasts that the financial crisis of 2008 and 2009 would lead to sharp increases in sales volume proved incorrect, predictions of a public-market-recovery-triggered turnaround in 2010 may also prove premature.

For one, it's unclear to what extent sellers who withdrew offerings last year will be returning to market. Two of the largest endowments to pull offerings last year, **Harvard Management Company** and **The Stanford Management Company**, for example, declined to comment on plans for secondary sales. And with public equity values up, endowments are under less pressure to sell fund stakes to reduce an overweight position in private equity.

Still, key indicators—from bid-ask spreads to dry powder sitting in secondary funds—hint that odds favor a pickup in activity. Following, we'll examine how the market uptick is impacting volumes, as well as how changing economic conditions may affect deal structures and pressure to put cash to work.

But first, we'll look at theories on why prior predictions for a record 2009 failed to pan out.

No Boom

Before seriously considering forecasts for secondary performance over the next few quarters, it's instructive to see how predictions for previous ones matched up against reality.

By and large, they were far off the mark. For 2009, NYPPEX was forecasting early that year that sales of secondary limited partner interests would total $27 billion, a 68 percent increase over the prior year. Around the same time, secondary investor **Lexington Partners** was expecting deal activity to jump to between $20 billion and $30 billion per year in the markets it tracks for the next two to three years.

The reality? NYPPEX estimates that $12.3 billion worth of secondaries actually sold in 2009, plus an additional $2.4 billion of unregistered securities in private companies. Over that same period, the firm estimates that an additional $13.8 billion in private equity inventory offerings was put on the market but later pulled, as buyer bids failed to match seller expectations. Estimates are based on surveys of customers with an aggregate of more than $550 billion under management, as well as analysis of deals the firm worked on internally.

Why no sales boom? **Jennifer Berrent**, an attorney at Wilmer Hale, ventures that much of the shortfall in sales can be attributed to seller psychology. By holding on to stakes—even those severely underwater—prospective sellers know they have at least a chance of recouping losses. "Until sellers don't think they're selling at an unnecessary loss, then they might as well hold on," Berrent says.

Market watchers may also have underestimated the allure and availability of alternate financing options for large LPs, says **Richard Lichter**, managing partner at secondary investment firm **Newbury Partners**, which raised a $700 million fund three years ago and is currently seeking to raise an $800 million Fund II , according to regulatory filings. A key reason for this, he says, is that in the years following the last big market crash in 2001, pension funds and large endowments have come to account for a much larger share of the private equity LP pie.

When liquidity needs arise, many of these LPs have the credit standing and connections to pursue alternatives such as bond deals. Stanford, for example, raised $1 billion in a taxable bond

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issuance a year ago, keeping most of the proceeds for what officials described as "a liquidity buffer for the university." The university had explored selling up to $1 billion in illiquid assets last fall, but pulled the offering, saying it was not seen as necessary for shoring up liquidity.

Smaller LPs, on the other hand, may feel more pressure to sell. Lichter says his firm, which typically does transactions in the $5 million to $25 million range, actually saw its most active year in 2009 in both the number of transactions and dollars invested. "It was family offices, smaller financial institutions, funds of funds," he says. "They had to sell, but they couldn't go around advertising… so they were all selling very quietly."

Forecasts

This year, seller lowballing is less pronounced. Allen of NYPPEX says he's no longer seeing extremely low bids—such as one-quarter of NAV—which he witnessed during the darkest days of the credit crunch.

Yet discounts, by and large, remain too deep for sellers' tastes, says **Jeffrey Bollerman**, who directs the limited partnership interest division at SecondMarket, a site for selling illiquid assets. "So far this year we have more generously priced stakes," he says. "But unfortunately it hasn't lifted so high as to meet seller expectations. There's a large bid-ask spread."

Nonetheless, Bollerman expects the secondary market to heat up over the course of the year, driven by cash-flush secondary fund managers looking to deploy capital. He says he's seen budding interest in particular in unfunded commitments, with buyers looking to acquire interests in funds that are less than 50 percent funded.

Placement agency Probitas Partners is particularly optimistic about the second half of the year. The firm, which runs a practice representing institutional sellers of secondary stakes, projected in February that by mid-year, top-tier buyout funds will trade near par, and median bids for all buyout funds will price above 80 percent of NAV.

The combination of increased and persistent demand should make for stable levels of transaction activity, Probitas says. In a survey conducted in November, it found that more than 75 percent of LPs are involved to some degree in the secondary market, and that the percentage is expected to increase further over the course of the year. About half of investors surveyed, excluding funds of funds, say they actively purchase direct positions in the secondary market. Forty-two percent of all respondents say they actively invest in secondary funds.

What are they looking to buy? Allen of NYPPEX says buyer interest has been particularly heated in the buyout market. In the first quarter, he says, buyout stakes saw the largest gain among asset classes he tracks, with prices rising to an average of 64.5 percent of NAV, up from 57.2 percent in the prior quarter.

Probitas's list of "in" asset classes, based on feedback from buyers, includes middle-market buyout, young funds, top-tier venture, energy assets, and fully-funded mega-buyout stakes. The "out" categories include distressed trading strategies, European venture, and unfunded mega-buyout funds.

Another growing category is direct purchases from early investors in venture-backed companies, says **Sam Schwerin**, managing partner at **Millennium Technology Value Partners**, purchaser of stakes in private companies. Rather than wait indefinitely for an IPO or acquisition, he says, "both angel and earlier stage investors are now interested in taking some of the chips off the tables on their winners."

As for terms, Berrent of Wilmer Hale says, they seem to indicate that buyer fears of impending financial markets disaster has lessened compared to a couple of years ago.

Back when markets were "teetering on financial ruin," Berrent says, prospective buyers writing contracts were negotiating a lot of material adverse change (MAC) clauses, which offer protection if something very bad happens before a deal formally closes. But during the depths of the financial crisis, Berrent says, such clauses were less prevalent, due to a sense that a near worst-case scenario had already occurred, and buyer bids reflected that.

Even now, she says, the clauses are not in as widespread use. However,

Private Equity Secondary Fundraising, 2001-2010

Year	No. of funds	Total Targets ($M)	Amount Raised ($M)
2001	12	5,800.00	4,552.40
2002	6	2,450.00	3,723.00
2003	19	6,960.60	5,058.80
2004	21	5,039.90	4,871.90
2005	13	6,725.00	5,946.90
2006	12	5,690.60	5,100.50
2007	17	9,466.40	13,549.80
2008	21	19,658.80	8,504.90
2009	16	26,612.40	16,448.70
2010	5	7,700.60	4,395.30

Source: Thomson Reuters

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How To Exit Without An Exit

Secondary deal-making is expected to rise across all private equity asset classes in the next several quarters. But one area in particular—direct purchases of company shares—will likely see the biggest increase.

For 2010, sales of unregistered securities in private companies are forecast to total $9.6 billion—a fourfold increase over last year's levels, according to secondary market maker NYPPEX. Many of those sales are expected to come from shareholders in venture-backed companies, who are looking for partial liquidity in advance of an IPO or acquisition.

"We're highly confident we'll deploy more capital," says **Sam Schwerin**, managing partner at New York-based **Millennium Technology Value Partners**, one of the firms poised to capitalize on an uptick in direct secondaries.

The 11-year-old firm, which purchases stakes in later stage, venture-backed category leaders, closed a $280 million Fund II in late April, after fundraising surpassed its initial target of $200 million. Millennium now has about $600 million under management, some of which it has used to purchase stakes in companies including Facebook, eHarmony.com, and shoe seller Zappos.com, acquired by Amazon.com last year for $940 million.

Schwerin says he's seeing an increased interest among early investors, founders and employees of venture-backed companies in generating at least partial liquidity for their shares as they await a full exit in the form of an IPO or acquisition. To date he estimates the firm has made about 300 secondary direct investments—with 2009 its busiest full year on record.

Though there's no restriction on how much or how little to invest, Shwerin says that the firm typically puts $5 million to $20 million in each company in its portfolio, typically deployed in multiple transactions over a year or two. Usually, the firm winds up with a 7 percent to 12 percent stake in the company, though there are exceptions, such as Facebook, in which it owns a much smaller stake.

Millennium is one of several funds that have ramped up in recent quarters to focus on direct investments in private companies, often with an eye to providing liquidity to employees and early investors.

Berrent says she'd see a rise in MACs as a positive indicator for present stability. The reasoning, she says, is that it would show buyers are confident the worst is past. Granted, it also indicates they're worried about some future disaster, but that's a standard precautionary concern in structuring a deal.

Secondary market players are also increasingly hedging risk through structured transactions that "bridge the gap between what a buyer would like to receive and what a seller would like to pay," says **Michael Belsey**, an attorney at Kirkland & Ellis. In recent quarters, deal structures that allow sellers to retain some participation rights have been particularly popular, especially in larger transactions, Belsey says. Generally, terms allow sellers the potential for some returns, even after selling a stake, should the underlying investments perform above a certain threshold.

Industry followers say bank capital reserve requirements, as well as strategic decisions by banks to offload non-core assets, may also spur more secondary sales. Banks including **Citigroup** and **Royal Bank of Scotland** are said to be exploring asset sales. RBS has taken numerous bids for its European private equity unit, according to *The Financial Times*, from buyers including Lexington Partners and **Alpinvest Partners**.

Sellers are also likely to free up more inventory now that it's less likely they'd have record a secondary sale at a drastic loss. As prices firmed early this year, sellers for the first time in nearly two years could transact without incurring a significant loss to their books. Partly due to improved pricing, portfolio sales began to re-appear in the market toward the end of the year.

Plenty in Reserve

For industry watchers, perhaps the most bullish indicator for the secondary space is the sheer amount of newly raised capital in dedicated funds looking for a place to invest.

Secondary funds raised an aggregate $16.5 billion in 2009 and $4.4 billion in Q1 of this year globally, according to **Thomson Reuters**, which tracks both fully raised funds and intermittent fundraising disclosures. The pace of capital-raising is markedly brisker than in 2008, when secondary firms raised $8.5 billion.

As of February, secondary specialists had approximately $33 billion available for investment, according to Probitas. In addition, the firm estimates that secondary specialists currently raising funds—including funds expected to come to market in 2010 and secondary direct funds—were seeking close to $26 billion in additional capital.

Some sizeable funds are being added to the mix too. **Landmark Partners** reportedly closed its fourteenth traditional private equity secondary fund with more than $1.9 billion in commitments this spring. The fund was targeted at $2 billion. Lexington Partners has also reportedly collected over $4 billion for its latest fund.

It all adds up to plenty of dry powder. With the market recovery taking some of the sting out of mark-to-market valuation, and sellers more agreeable to prevailing bid prices, it looks as if the stage is set for several active quarters of secondary deal-making.