Secondary Firms Struggle With White Knight Role

By Daniel Hausmann

In 2009, the secondary fund market is going to be front and center. But it may not be ready.

With limited partners over – in some cases, well over – their private equity target allocations, the secondary market offers one of only a few viable alternatives for relief. Some smaller deals have already been done, such as listed fund of funds **AIG Private Equity Ltd.**'s $54 million sale of a few fund stakes. Other, larger ones are on the horizon, including sales of portfolios by **Harvard Management Co.** and **Duke Management Co.** that are said to be worth north of $1 billion.

However, there is some question as to whether the secondary market is going to be able to provide solace to all those who seek it. The barriers are many, from deal prices that are so low that they may drive all but the most distressed sellers away, to a lack of dry powder among secondary buyers to do deals, to legal constraints that were mild annoyances before but may be major stumbling blocks now, given expected transaction volume in 2009.

"There are a number of issues involved in getting secondary transactions done," said Sean Hill, an attorney with Proskauer Rose. "These have been compounded recently by the increased amount of limited partner interests for sale and price dislocations."

Differences between buyers and sellers on price may ultimately be the easiest of these hurdles to leap over, with the passage of a little time likely to bring the parties closer together.

Nightmare Valuations

Sellers became accustomed in 2006 and 2007 to getting premiums to net asset value for virtually anything they sold. The high bid for a fund stake averaged 104.1% of net asset value in 2007 across all types of firms, according to intermediary **Cogent Partners**. But in the first half of 2008, as the prospects for quick realizations and hefty profits dimmed, that figure fell to 84.7%, and in the second half of the year through November, it was even lower, at 61% of NAV, Cogent said.

The rapid change has left many limited partners shell-shocked and reluctant to sell when they hear just how little their fund stakes will fetch. One secondary intermediary said that only 4% of the deals on the market appear likely to close for this reason.

But many believe the dislocation is temporary. Limited partners who need to shift massive uncalled commitments that they no longer have the capital to fund will have to come around.

"I think we'll see more willingness on the part of the institutions to actually transact," said Cogent Managing Director Colin McGrady.

And NAVs reported by GPs, which a recent Cogent report called "at best stale, and at worst a fantasy" will ultimately come down, although perhaps not as far as they should. That will make the discounts sellers are offering less steep. It will also provide incentive to LPs to sell, as they will see writedowns whether or not they keep funds within their portfolios.

"I would think that we're going to see more realistic valuations come in on Q4," McGrady said. "As always with general partners, hope springs eternal so I'm sure they'll argue for the best possible value, but I'm sure valuations will come down."

Capital Constraints

A bigger issue lies in the capacity of secondary buyers to do a lot of deals. Until recently, the industry has been relatively small, and while a few players, including **Coller Capital**, **Lexington Partners**, **Goldman Sachs Group Inc.**'s secondary arm and **Axa Private Equity** raised giant funds in recent years to take advantage of massive increases in fund-raising by primary firms, even they weren't ready for the much larger volume of opportunity that has appeared in the wake of the credit crisis and economic downturn.

U.S.- and European-based secondary funds have raised about $22 billion since 2006, according to our fund-raising statistics, but much of that is already invested. That leaves some questioning where the capital is going to come from to absorb the record deal-making that secondary players anticipate in 2009, with estimates of deal volume ranging from $25 billion to nearly double that.

"There isn't the ratio of dry powder to projected market volume that there has been in the past," McGrady said.

Plenty of secondary firms are currently in the market trying to remedy this problem, including Lexington, **HarbourVest Partners**, **Paul Capital Partners** and Goldman Sachs. But this process isn't going to be a walk in the park, since many of the investors in the large secondary funds are those very investors who are now over-committed to the asset class.

"Secondary funds are topical, with interest (from LPs), but there is just less money to invest," said one secondary intermediary. "Even if they write a check, they'll write a much smaller check than usual."

California Public Employees' Retirement System, which recently had to expand its private equity allocation range because it was so far above target, committed $375 million to Coller Capital's most recent fund. It has also been a consistent backer of Lexington's funds. Lexington, in fact, appears to have delayed an intended new fund that it first spoke of raising in fall 2007, although its reasons are unclear.

Some secondary buyers may also face questions over their use of debt as they return to the fund-raising trail. While no one will admit to layering on debt to provide a boost to the equity used to buy fund stakes, this practice is widely acknowledged to have been common during the easy credit of the boom years. Industry participants say roughly 25% of deals done prior to summer of 2007 were levered, by as much as 30% to 50%.

That could come back to bite firms in 2009, as reported NAVs on underlying funds really begin to come down. As that happens, secondary players could face capital calls from banks that will have to be financed with more equity. Or, they might have to pay the interest on their debt with equity rather than distributions, since the latter are now few and far between. Neither of these scenarios will make secondary fund LPs particularly happy.

One investor said that if a secondary fund defaults on its debt, the creditors could go after uncommitted capital, future distributions or even claw back capital already distributed to limited partners.

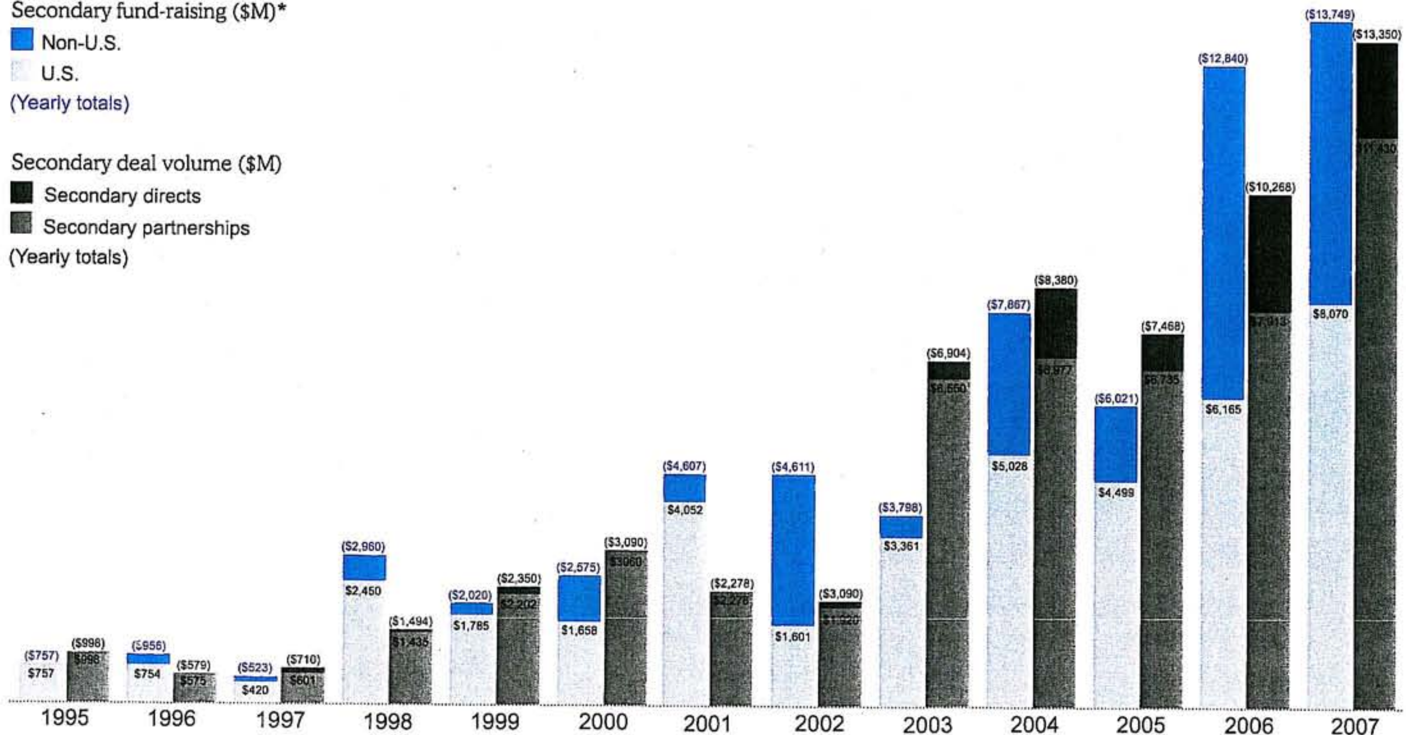
Even if buyers and sellers manage to overcome these hurdles, there's one last roadblock: the general partner of the fund that's up for sale.

Tackling The Taxman

Most, if not all, limited partnership agreements contain clauses giving the general partner discretion to approve a fund transfer. A GP can reject transfers simply because it doesn't like the proposed buyer, or perhaps because it wants to avoid the stigma that LPs are selling off interests because the fund is underperforming. In one recent example, **Belvedere Capital** rejected the proposed buyer that **California Public Employees' Retirement System** had found for its stakes in the bank-focused firm's funds, in favor of **Newbury Partners**, a secondary firm it already knew via a previous stake sale.

"For smaller GPs, it's important who the lead investors are," said Richard Lichter, managing director of Newbury.

Historical Secondary Market Fund-Raising & Dealmaking



*Includes only dedicated secondary funds.

Sources: Lexington Partners Inc., *Private Equity Analyst*

"They may not want to accept replacements" that come out of auctions.

In an environment in which the majority of LPs seem to be in trouble, fund managers have a major additional reason to watch transfers carefully: If more than a certain percentage of a partnership changes hands in one year, it could be classed as a publicly traded partnership by the Internal Revenue Service, raising serious tax issues.

Michael Harrell, a fund attorney with Debevoise & Plimpton LLP, said he hasn't seen a crackdown on secondary sales by the government in his 20-plus years in the industry, and believes most funds should be able to comply with IRS safe harbors by limiting transfers. But he cautions that this is indeed a matter worth paying attention to.

"It may be a narrow crack, but it's a deep hole," Harrell said. "It's really bad news if you blow it."

The limit is typically 2%, although there are ways to expand that to 10%, including by using "qualified matching services," such as one run by NYPPEX. However, this year some industry participants think larger percentages of funds than that could change hands.

When secondary sales do exceed the limits that general partners deem acceptable, GPs can put limited partners in a queue to wait their turn to sell stakes. Some say they're already seeing lines stretching into 2010.

In such cases, secondary buyers may agree to cover capital calls even before the interest is transferred. Limited partners often hide such arrangements from general partners, who worry that they might violate the tax code anyway.

Biting The Bullet

Despite all these issues, most industry participants agree that 2009 will be a record year for secondaries, if not quite as large a record as many predict. Many secondary firms will be able to raise funds by looking to non-traditional investors. One secondary buyer that plans to close a multi-billion dollar fund in 2009 said it has been able to raise a "material" amount of capital, in part by looking to new investors that include sovereign wealth funds and small- to mid-sized institutions that are getting into private equity for the first time.

Other players that do secondary deals more opportunistically, including a few large limited partners like **AlpInvest Partners NV** and some of the larger funds of funds like **Adams Street Partners**, are likely to shift more of their attention to this area and away from primary fund commitments in 2009. Listed fund of funds **Conversus Capital**, for example, said in November that it expects secondary purchases to make up roughly half its investment activity over the next year. **New Jersey State Investment Council** said in December that while it intends to cut the amount of capital it has available for new investments to between $500 million and $750 million in 2009, the majority of this capital will go toward secondary deals. Even some LPs that previously haven't been known for their participation in the secondary arena are diving in. In one small example, **Nebraska Investment Council** recently agreed to pay about $6 million to take a stake in Abbott Capital Private Equity Fund V LP off the hands of Bayer Corp.

In the end, this is an industry that's used to being creative to get deals done, and undoubtedly it will adapt to this market just as it has to previous ones.

"If (buyers) have the bullets, it's going to be a target-rich environment," McGrady said. ■

Price Changes On Secondary Market, 2007 Through Today

	Average High Bid (% Of NAV)		
	2H 2008	1H 2008	2007
All Funds	61.0%	84.7%	104.1%
VC Funds	55.0%	81.3%	102.9%
LBO Funds	64.7%	85.0%	108.7%

Source: Cogent Partners