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15 December, 2008

LPs Rush For Exits, Overwhelming Secondary Market

What looks like a record sell-off of private equity interests has begun.

As public market valuations fall, the percentage of other assets in a portfolio, including private equity, rises. This phenomenon, known as the "denominator effect," has triggered the need for many limited partners, Harvard University and Columbia Univesrity among them, to try to sell private equity interests in the secondary market as a means of portfolio rebalancing. Others, such as the California Public Employees' Retirement System, are selling limited partnership shares to streamline the number of manager relationships and reduce administrative burdens.

Further, the arid exit market has dammed capital distributions, spreading concern among institutional investors like Duke University that they will not be liquid enough to fund upcoming capital calls. "Now that the level of distributions has diminished, LPs realize the prospect of heavy capital call activity looms when banks begin lending to general partners who will try to buy companies at these lower market values," said Richard Lichter, managing director, Newbury Partners.

In fact, 2008 has already been a record-breaking year in terms of secondary deals completed. At the close of the third quarter, secondary deal volume reached $13.7 billion—surpassing full-year 2007's record of $13.4 billion—and it's projected to hit $17.0 billion by year end, according to data from secondary buyer Lexington Partners. The firm expects that number to jump to $20 billion to $30 billion per year for the next two to three years, as the market sees its partnership interest turnover rate jump from nearly 5 percent to as much as 10 percent, according to Brent Nicklas, a managing partner at secondary buyer Lexington Partners. Indeed, all told Buyouts Magazine has identified seven institutional investors who have recently sold or are looking to sell more than $30 billion of interests in limited partnerships on the secondary market—see table.

"I've never seen this amount of activity as a secondary agent—the number of people coming to us with portfolios to sell," said Kelly DePonte, a partner at Probitas Partners, which advises limited partners on issues of portfolio management.

The implications of a robust and protracted secondary sell-off are many. The rush to sell by some very smart investors, like Harvard University, could prompt other LPs to lose some faith in their investments, regardless of the motivations behind the selling. The result could be something akin to a run on the bank.

The flood of interests on the secondary market could also convince some investors that the best deals to be had in the asset class are to buy secondary interests on the cheap, rather than to

commit money to primary funds at par. Investors may be especially interested in obtaining interests in funds previously considered invitation-only. This could have a dampening effect on the primary fundraising market in months to come.

As for general partners, they face the challenges of handling requests for LP interest transfers. These can involve vetting the new LPs to make sure they're able to make future capital calls, and in some cases introducing them to the firm and its investment strategy.

Longer term, the rush to sell interests on the secondary market could signal larger problems for buyout shops. Waning confidence in the ability of peak-year funds raised between 2005 and 2007 to generate strong returns has provided even more fodder for the secondary market. Struck with buyers' remorse, some investors are looking to sell those assets and redeploy capital into new private equity funds that will buy at the bottom of the market instead of the top. This could suggest the start of a fundamental shift in attitude toward the asset class, just as many investors lost faith in venture capital after the dot-com bust.

First Rumblings

The influential CalPERS got the latest wave of selling going with a $2.1 billion sale of private equity assets between the third quarter of 2007 and third-quarter 2008. Eighty partnerships representing 60 different GP relationships in venture capital, distressed and buyout funds were sold to reduce the administrative burden of having so many funds to oversee and to optimize long-term private equity performance, the state said.

Troubled financial firms like AIG and Lehman Brothers launched a wave of selling earlier this year. Last month, for example, AIG said it would sell its limited partner interests in buyout funds Avista Capital Partners and Sun Capital Partners V in hopes to raise about $21 million. And Lehman Brothers sold part of its $3 billion private equity portfolio at a 50 percent discount, according to Fortune Magazine.

Endowments at Columbia, Duke and Harvard, meantime, have also joined the parade of sellers, saying they need to distribute cash to their universities. At least six university endowments have sold portfolios, are trying to unload interests or are mulling the sale of interests adding up to roughly $5 billion of private equity assets. Harvard and Columbia, both seeking to rebalance their portfolios, received low-ball bids on the total of $2.5 billion of private equity assets they recently put on the market and are contemplating how to proceed. Duke is considering the sale of $200 million of its private equity holdings to gain liquidity. And the University of Virginia stated that while it doesn't need to sell investments in private funds, it is exploring the secondary market and will consider buying or selling private funds at attractive prices.

"University endowments are very nimble institutions that move more quickly, and we could see a similar thought process next year with other large investors in private equity, such as pension funds," said Colin McGrady, a managing director at Cogent Partners, a provider of investment banking services to the secondary market.

Indeed, secondary investor Paul Capital Partners is holding talks with several pension funds related to portfolio restructuring, said Bryon Sheets, general partner at the firm. Sheets said he is working with public pensions trying to raise cash by selling down their 2006 and 2007 vintage exposures and others seeking relief from unfunded capital calls. In this buyer's market, sellers find they can only sell partial, rather than whole, portfolios, so LPs are discussing alternative transaction structures with Paul Capital. These include joint ventures in which the LPs trade an ownership interest in their portfolio to the secondary buyer, who then agrees to cover all future capital calls.

Also looking ahead, banks and other financial institutions may end up selling more LP interests next year. With the Federal Reserve taking more of an interest in the balance-sheet strength of financial firms, the government could force financial institutions to have a larger ratio of capital to private equity holdings than they currently have. "Regulatory changes in 2009 is one of the things to keep a look out for," said Probitas Partners's DePonte.

Bargain Prices

So many limited partnership interests have come to market that supply is overwhelming demand, arguably leading to depressed pricing. That in turn, has led to some pent-up activity, as sellers not absolutely desperate to unload their interests pull back, discouraged at the offers they're getting.

In terms of market discounts, Dec. 1 median bids for top-performing buyout funds represented only 65.80 percent of their Sept. 30. net asset values, according to NYPPEX Private Markets, a secondary market intermediary. Those same funds were commanding median bids of 100.60 percent of NAV just 11 months ago. Those bids correlate to, but still fall short of, the 44.1 percent year-to-date decline in the S&P 500 Index. Because buyout-backed companies tend to carry more leverage than their public market comparables, some expect the next crop of financial statements from buyout firms to reflect further declines in NAV.

"A lot of the institutional investors look and figure that with FAS 157 they're likely to see pretty significant write-downs at some point, so they're forced to ask themselves: 'Do I want to take a 40 cent on the dollar write-down and have no liquidity, or do I want to sell at a 50 percent discount to NAV but have the liquidity right now?'," said Cogent Partners's McGrady. Cogent Partners represents clients seeking to sell between $4 billion and $5 billion worth of private equity interests for sale on the secondary market.

Recent-vintage mega-funds apparently are taking the brunt of the sell-off. According to sources, funds managed by Apollo Management, The Blackstone Group, Kohlberg Kravis Roberts & Co., Madison Dearborn Partners and Silver Lake are all trading below 60 cents on the dollar, with some even selling below 50 cents on the dollar.

NYPPEX last month released a report naming 10 brand name buyout funds that were active in the 2005-2007 time period that it believes will see asset write-downs of 40 percent to 80 percent next year. Among those listed is the $4.2 billion Providence Equity Partners V LP, which respectively levered their average deals at 11.8x and 10.9x EBITDA during the peak period,

according to the report. A spokesperson for Providence Equity Partners took issue with the report, however, and said, "NYPPEX's survey uses an analysis of Providence's investments that is flawed on several levels, resulting in an inaccurate and inflated average debt to EBITDA multiple for acquisitions."

Enterprise value to EBITDA multiples for large market U.S. private companies have contracted 20 percent or more in the 12-month period ended Oct. 31, 2008, according to NYPPEX. Those losses will be magnified on investments that used at least 60 percent leverage during those peak years, the firm contends.

Other funds listed by NYPPEX that could see large write-downs next year include Blackstone Capital Partners V LP (which the report said used mean leverage of 10.6x EBITDA during the peak), and Carlyle Partners IV LP (9.6x, according to the report). Blackstone and The Carlyle Group were not immediately available for comment.

But buyers looking for the cheapest secondary deals may want to make their plays sooner rather than later. The perfect storm of public market volatility and economic uncertainty mixed with a glut of high-profile LPs looking to exit their private equity holdings at a discount is bound to dissipate before too long.

The discounts at which secondary assets are trading today are based on estimates of write-downs to portfolio companies during the tumults of October and November. Once LPs receive their updated year-end NAVs, they can write down their portfolios accordingly, and the pricing will more accurately reflect reality without the blur of panic.

Laurence Allen, a managing member at NYPPEX, predicts that once the NAVs are updated, the discount that funds are currently trading at will narrow by about 15 percent. NYPPEX currently is brokering about $1.1 billion in LP interests on the secondary market.

“Many sellers have investment committees that cannot get comfortable with 45 to 50 percent discounts to NAV,” Allen said, adding that a rebound of 15 percentage points in pricing would be enough for sellers to more willingly part with their holdings.

In the meantime, secondary buyers are warming up to take advantage of the increased supply of LP interests that are up for sale—a number that could reach as high as $100 billion before the multi-year sell-off is complete, according to sources. With so much supply poised to hit the market, prices are expected to remain under pressure.

About $26.0 billion has been raised by secondary investors thus far in 2008, versus about $14 billion in all of 2007; an additional $16.5 billion is poised to close in 2009, according to Lexington Partners, which seeks about $5.0 billion for its new global secondary fund, Lexington Capital Partners VII. Other firms in the market are Goldman Sachs, targeting $3.0 billion to $5.0 billion for GS Vintage Fund V, and Pomona Capital, which has exceeded $1 billion and is nearing the final close of its seventh secondary fund.

“I think many investors will reduce relative appetite for new primary blind pools in favor of upping commitments to secondary funds, and as a result I think likely near-term supply/demand imbalances will be rectified,” said Newbury Partners's Lichter, who expects to begin raising his firm's second fund sometime next year.

By Ari Nathanson