Secondary Market Poised To Lift Off

By Tom Stein

Secondary buyers have been predicting big things for their market for some time. Now it finally seems to be coming to pass.

After a dismal 2009, in which only $8 billion worth of private equity assets were traded on the secondary market, 2010 is shaping up to be a record year. Total volume for the year is expected to reach $25 billion, easily surpassing the previous record of $15 billion set in 2008, according to private equity advisory firm Triago.

For investors like **David de Weese**, a partner at secondary buyer **Paul Capital**, this is just the tip of the iceberg. "I could see the market going to $30 billion or $40 billion next year," he said. "There are huge opportunities developing and they are beginning right now."

Indeed, both general and limited partners need to be prepared for a flood of secondary deals in coming months, and their impact. For GPs, a rapidly expanding secondary market could mean a revolving door of investors. Time will have to be spent evaluating and approving new investors, as well as educating them about the investment strategy of the fund. It means that fund performance becomes an open secret if secondary transaction prices get leaked to the public. And, in raising new funds, buyout shops will increasingly have to compete for capital with secondary buyers who will be promoting to investors a potentially cheaper and more liquid way to get exposure to private equity. For LPs, an active market means an opportunity to snap up some bargains, either by directly purchasing secondary positions or by investing in secondary funds.

What is the bullish case for the secondary market? For starters, **Richard Lichter**, managing partner at secondary investment firm **Newbury Partners**, estimates that there is now roughly $1 trillion in unfunded private equity commitments. This is bad news for many cash-strapped investors, including banks, that are looking to unload their positions. After all, the last thing they need right now is a capital call from the likes of **The Blackstone Group** or **Kohlberg Kravis & Roberts**. "Rest assured, those calls are coming," said Lichter. "And when those capital calls do go out, holders of private equity are obligated to meet them."

In addition, de Weese and others see a number of financial services firms under the gun to unload the bulk of their private equity holdings. All told, de Weese believes there is an eye-popping $300 billion to $400 billion of private equity exposure that needs to be unwound by large banks in the United States and Western Europe.

Sellers Proliferate

Indeed, it's no secret that financial institutions have their backs to the wall. They are under increasing regulatory pressure to restrict their exposure to private equity. Governments and financial regulators are hammering out new rules, including Basel III and the Volcker Rule in the United States, which will make private equity investing a lot less attractive for financial institutions and possibly even prevent them from creating their own private equity vehicles.

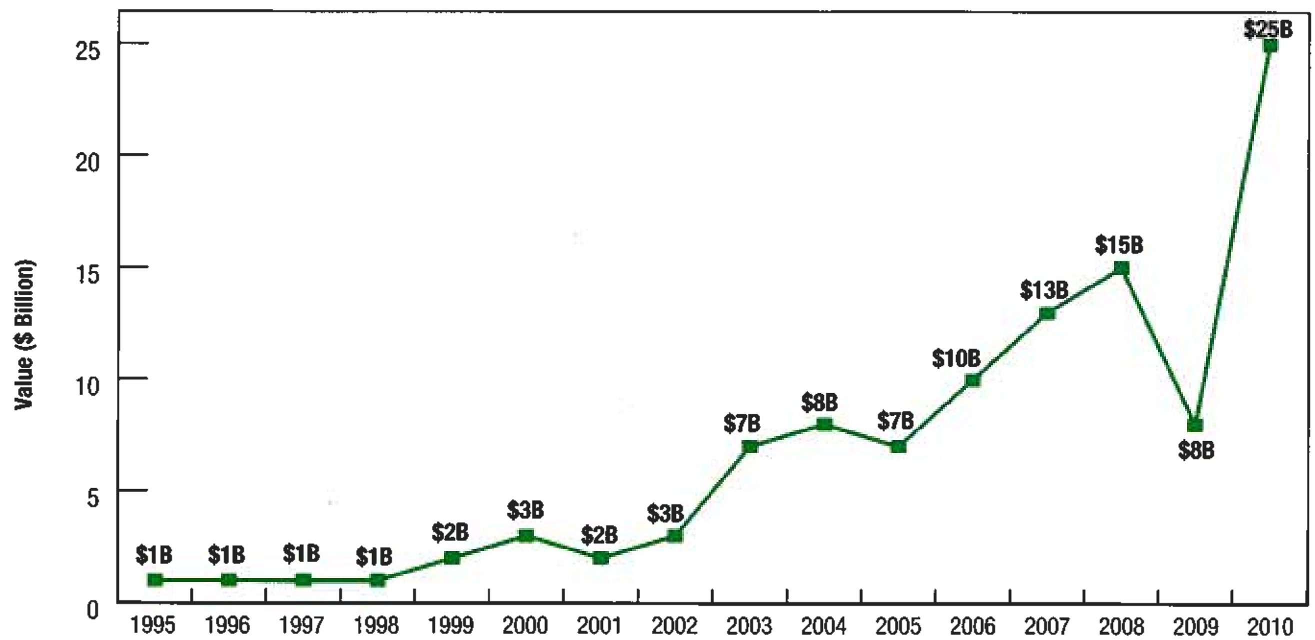
This year saw the start of some of that unwinding, with **AXA Private Equity** purchasing part of **Bank of America's** private equity portfolio for $1.9 billion. The deal was the largest transaction on record in the secondary market. That transaction was closely followed by news that **Citigroup** was selling $1.2 billion worth of private equity investments to secondary specialist **Lexington Partners**. "This is just the start," said de Weese. "You are going to see one bank after another in this market."

The new regulations will be phased in over the coming decade, which means that most buyers are not anticipating any fire sales just yet. But they do expect a steady flow of deal-making over the next several years.

"We really saw the regulatory issues take hold this year and spark activity," said **Brent Nicklas**, a managing partner at Lexington Partners. "On top of that, pricing was up this year compared with last year, so banks were in financial position where they could afford to divest their private equity holdings."

Secondary Market Rising

(Annual Deal Volume)



Source: Preqin

Indeed, record low pricing was a huge obstacle to deal-making last year, preventing all but the most desperate sellers from completing transactions. For most of last year, secondary buyers were only interested in purchasing private equity holdings at half their net asset value, and almost nobody wanted to sell for that cheap, resulting in low deal volume.

In fact, a number of highly publicized transactions fell through in 2009 because buyers and sellers could not agree on pricing. **Stanford University** cancelled plans to sell up to $1 billion in private equity holdings on the secondary market, while **Columbia University** put the brakes on a $600 million portfolio sale.

Today prices have perked up considerably, with buyers on average agreeing to a slight discount of about 10 to 20 percent, according to Triago. With the economy stabilizing somewhat, both buyers and sellers have greater confidence in near-term valuations. They are in a better position to see common ground and complete deals.

"I think some sellers are looking back at the depth of the downturn and are just happy they didn't get wiped out," said **Brett Byers**, a managing director at **VCFA Group**, which specializes in buying secondary positions. "They are more inclined to sell under the new circumstances, especially compared to what could have happened to them."

The secondary market is clearly already beginning to feel the impact of better prices. Nicklas at Lexington Partners said that 2010 was an extremely hectic period for his firm. In the first nine months alone, the firm completed seven transactions totaling approximately $2 billion. "This was the busiest time we ever had," he said. The firm's biggest transaction was the $1.2 Citibank deal.

Capital Supply Growing

Not only are there more sellers in the market these days, there are also more buyers. Given the growing level of activity in the market, it's not surprising that new players are trying to get a foot in the door.

"In the wake of the downturn, some private equity firms were not able to raise new funds. Those partners are now looking around for what to do next," said Byers of VCFA Group. Clearly, some have come to the conclusion that the secondary market is the hot place to be. "We are seeing some new boutique funds, but they're not a real factor yet," said Byers.

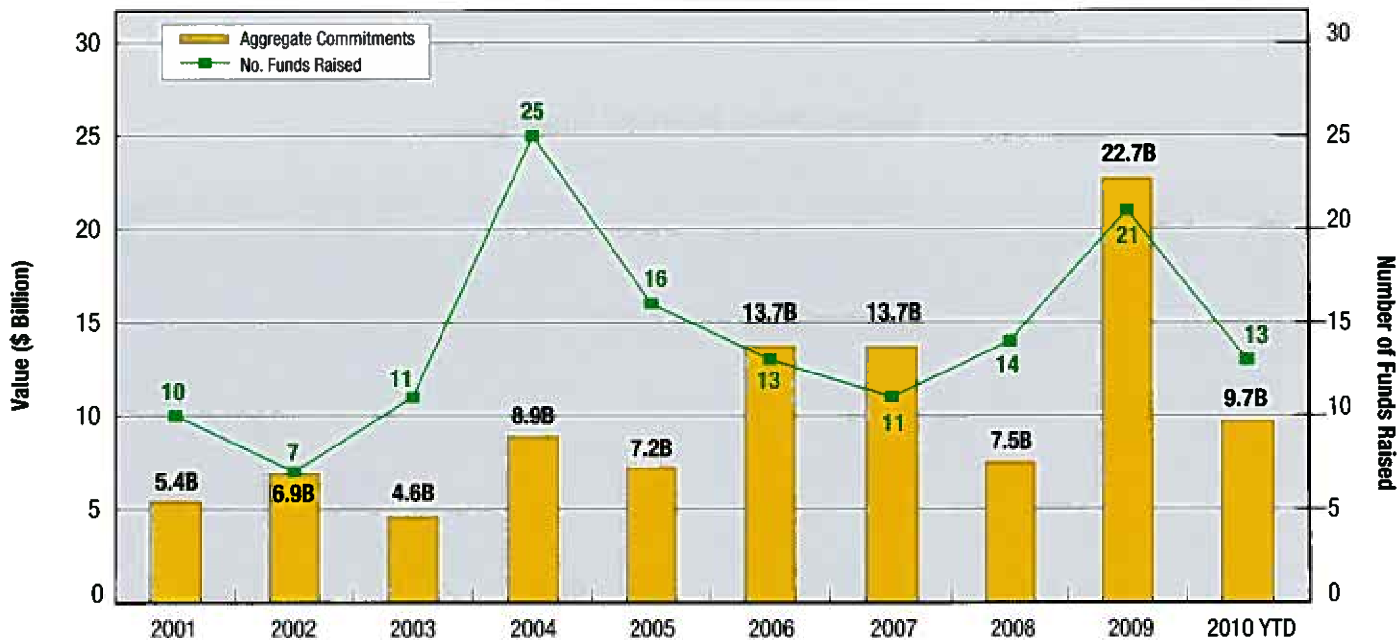
The secondary market is also playing host to a number of "hobbyists" or "tourists." These are institutional investors like pension funds and sovereign wealth funds that have traditionally invested through the primary market, but are seeing more attractive opportunities in the secondary market. "Instead of waiting for firm X to come out with a new fund in two years, these guys are seizing the chance to get in right now through the secondary market," said **Jean-Marc Cuvilly**, managing partner at Triago.

One such investor is **China Investment Corporation** (CIC), China's sovereign wealth fund, which roared into the secondary market this year with $1.5 billion to spend. The upside for CIC is the ability to invest in well-established funds it might not have had access to otherwise—and likely at a discount.

"The universe of buyers is no longer just a handful of secondary funds you hear about in the press," said Cuvilly. "The number of potential buyers has grown from about 30 usual suspects eight years ago to some 400-plus buyers today."

Meantime, traditional players have plenty of capital to spend themselves. Newbury Partners recently closed a new $1 billion fund to capitalize on the opportunity. Other secondary firms with new funds include Lexington Partners, which just raised more

Ups, Downs Of Secondary Fundraising



Source: Preqin

than $5 billion, its largest fund to date. And AXA Private Equity is targeting up to $4 billion for its newest secondary fund.

If anything, such funds are under even more pressure than the more opportunistic entrants to put capital to work and start doing more deals, especially after an anemic 2009. Triago's Cuvilly estimates that secondary funds still have about $50 billion in dry powder.

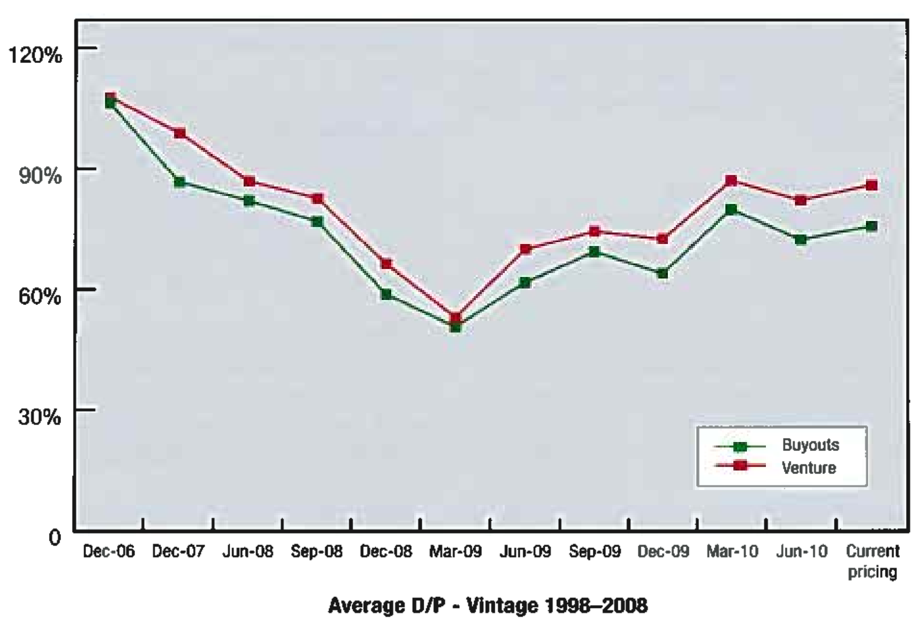
"You saw a large number of secondary funds raise big pools of capital and they had trouble putting it to work in 2009," said Cuvilly. "The theory was that '09 would be a great year because you could pick up assets cheaply." That never happened, however, and secondary funds realized they had to make up for lost time, or face the specter of handing back money to their investors. "That when pricing came roaring back very quickly," said Cuvilly.

With growing competition, it's incumbent on pure-play secondary funds to separate themselves from the pack, or risk getting squeezed out. This could mean taking an innovative approach that no one else is following. For Paul Capital, innovation is coming in the form of emerging markets. The firm recently established offices in Sao Paolo and Hong Kong, and is now allocating fully 20 percent of its $1.65 billion fund to emerging market opportunities.

"We are the only secondary buyer from Mexico City to Buenos Aires, so we have a whole continent to prospect in," said Paul Capital's de Weese. "We have seen some very attractive deals." The firm typically buys secondary positions from local development banks, insurance companies and wealthy families who often have no idea they can sell their private equity holdings on the secondary market. The strategy has proven so successful that some of Paul Capital's LPs are asking the firm to allocate an even larger percentage of the fund to these deals. "At the moment, we don't have a lot of competition, so we can be very selective about what we do," said de Weese.

Given the changing dynamics of the secondary market, it's very possible that 2011 will provide even greater opportunities. "I think everyone expects to see continued growth in the market," said VCFA Group's Byers. Now it's just a matter of buyers and sellers agreeing on the right price. ❖

Historic Secondary Pricing as % of NAV



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