SECONDARIES

Waiting for the tide

OVERVIEW

The year of the seller?

Secondary market deal activity declined dramatically in the first half of 2013, amid strong public markets. Secondary buyers have been waiting for the floodgates to burst open, writes Christopher Witkowsky

Talking to secondary market professionals about the dynamic in 2013, the term "window of opportunity" gets thrown around a good bit. Many have been sitting around this year waiting for sellers to open that 'window' by coming to the market.

Deal activity on the secondary market in the first half of 2013 was more than 50 percent down on the equivalent period in 2012, according to the latest pricing report from Cogent Partners. In 2012, the market saw about $13 billion of activity; this year, around $7 billion of deals were done.

However, Cogent believes total secondary deal activity for the year will be somewhere between $18 billion to $20 billion. Placement agency and secondary advisor Triago takes a similar view, pegging likely deal volume for 2013 at around $20 billion.

For this to happen, activity will have to pick up substantially in the second half. And this would have to be driven not just by the many small and specialised transactions that have dominated the market so far this year, but by large portfolio deals as well.

As things stand today, it does appear that deals are starting to trickle back into the market. The hope among secondary buyers is that this trickle will become a flood in the latter half of 2013.

"I just don't think the supply was enough in the first half," says Hugh Perloff, managing director with Portfolio Advisors. "And the supply that was there wasn't really supply, it was people putting out feelers – if people met their expectations, they sold. Now we're seeing more stuff coming into the market. I'm of the opinion that the second half will be much more active than the first half, which is traditionally the way the market has run. I'd like to believe we'll see some pretty robust activity."

WHERE DID IT ALL GO?

So far, 2013 could be characterised as the year of the seller – a period when vendors had access to some extremely attractive pricing for assets.

According to Cogent's half-year report, pricing levels remained strong throughout the first half of 2013, with the average high first round bid for all funds at 84 percent of net asset value, up from 80 percent of NAV in the second half of 2012. Pricing was particularly robust in the buyout segment, which saw average high pricing of 89 percent of NAV.

Despite pricing levels, many sellers chose to stay out of the market. The reason? Several secondary professionals have told *Private Equity International* that it ultimately boils down to a "fear or greed" calculation. As long as sellers are confident that the public markets will remain strong, and net asset values continue to rise, they will be happy to hold on to their private equity stakes for at least another quarter. After all, what is the motivation to sell?

The Dow Jones Industrial Average broke through a record 15,000 earlier this year – a symbol of the high-flying nature of public equities. Marketable securities are generally the largest piece of an investment portfolio, and so strong performance will raise overall fund performance, potentially under-allocating private equity.

In this situation, selling private equity would under-allocate an institution even more, so it may not make a lot of sense to pursue secondary sales, which also raises the issue of where to put the proceeds -- back into private equity?

> ***There's demand from buyers, and we see many GPs looking to clean up old NAV to raise the next fund***
>
> **Larry Thuet**

"Assets seem pretty sticky in owners' hands today," says John Toomey, managing director with HarbourVest Partners, who works on the secondary team. "Many prospective sellers have the attitude of: 'Why sell today when I can hold on for a higher price and higher NAV in the future?' [But] that won't go on forever. Eventually the pendulum will swing from greed to fear – and sellers will start to sense: 'Maybe I missed the boat and I need to sell as soon as I can'."

It's notable that large portfolio sales have been largely absent from the market this year, with the exception of some activity from European banks. "The traditional type of deals are more difficult in this market," says Perloff. "You have to work hard to source them [and] you have to keep pricing discipline."

However, Canada's Public Sector Pension Investment Board, which oversees about C$76 billion in total assets, brought a portfolio of around eight fund interests valued at about $1 billion to the market in the summer, several sources in the market told *PEI* in July. At the time, the portfolio was one of the biggest on the market in the year to date – and was perceived as a potential sign of things to come in the rest of 2013.

Hugh Perloff: *expecting a strong second half*

> ***Assets seem pretty sticky in owners' hands today***
>
> **John Toomey**

RESTRUCTURINGS AND DIRECTS

Nonetheless, despite the slowdown in activity, $7 billion of activity in six months is not to be sniffed at.

And as Cogent pointed out in its pricing report, although some of the more traditional sellers (i.e. financial institutions and pensions funds) have been less active, new groups of sellers have continued to emerge – including GPs needing to restructure ageing funds.

"As many funds raised in the late 1990s and early 2000s approach or extend past the end of their finite terms, managers are now increasingly proactive with respect to alternative liquidity methods that both alleviate timing pressure and expedite the return of capital to their investors," Cogent said.

Earlier this year, HM Capital Partners was broken apart with help from secondary firms, illustrating one model the market can use to inject life into older funds and firms.

HM Capital's food and consumer products team was spun-out in a $606 million transaction by the Canada Pension Plan Investment Board. The pension fund used $468 million to buy a portfolio of food-related companies from HM Capital, managed by the newly-formed firm, Kainos Capital. CPPIB also committed $138 million to the Kainos fund, which was targeting $400 million. Existing HM Capital LPs had the option of rolling over their interests into the new vehicle.

Separately, HM Capital's energy investment team also spun-out from the firm with the help of secondary firm Landmark Partners. Landmark financed the creation of a $400 million vehicle to house two energy-related portfolio companies. The vehicle is being managed by Tailwater Capital, a new firm run by former HM energy specialists Jason Downie and Edward Herring. LPs in HM Capital's prior fund also had the option to run their interests over into the new vehicle.

The transactions splitting different business lines out of HM Capital, a firm that has been winding down, is one way the secondaries market (or even other interested parties like large pension plans), can help breathe some life back into older funds.

There are of course other ways to go about restructuring old funds in order to generate liquidity for limited partners (including direct deals simply buying strips of portfolio investments out of funds). But whatever the model used, it's clear that the market for GP-driven transactions is large and growing. One estimate from Pantheon has just under $100 billion of net asset value residing in about 250 funds that are at least 10 years old.

"There's demand from buyers, and we see many GPs looking to clean up old NAV to raise the next fund. We don't see that dynamic changing in the short run," says Larry Thuet, senior managing director with Park Hill Group.

So it looks like there'll be at least one window of opportunity open to secondaries players for a long time to come... ■

DEALFLOW

Where have all the big deals gone?

Secondary sales of $1bn or more have essentially disappeared in 2013 – but a resurgence is expected before year end, writes Graham Winfrey

From just about every angle, the private equity secondaries market looks very different today than it did in 2012. Deal volume is down, and pricing has been getting stronger, according to secondaries broker Cogent Partners.

One of the most significant changes during the past year has been a lack of the large secondary portfolio sales that were commonplace in 2011 and 2012. Last year, China's State Administration of Foreign Exchange (SAFE) bought a portfolio of private equity stakes from General Motors' pension plan for somewhere between $1.5 billion and $2.5 billion, while Swedish life insurance company Länsförsäkringar sold a €1.5 billion private equity portfolio to two buyers – the Abu Dhabi Investment Council, which bought the bulk of the offering, and Australian institutional investor QIC.

Then there was Lloyds Banking Group's sale of a £1 billion portfolio to Coller Capital, the State of Wisconsin Investment Board's offloading of a portfolio of 12 private equity funds for about $1 billion and the California Public Employees' Retirement System sale of at least $1 billion of private equity interests.

NO PRESSURE

One reason for the drop in big-ticket secondary deals this year has been the healthy environment for asset sales on the primary side. A strong level of exits meant distributions to limited partners hit $48.6 billion during the fourth quarter of 2012, the largest quarterly distribution on record and a 123 percent increase on the previous quarter, according to Cambridge Associates. Total distributions for the year stood at $118 billion, also the highest figure in the 27 years since the inception of Cambridge's US Private Equity Index. This reduced any pressure to sell.

"You've had strong exit routes and a refinancing market that's been very prevalent in the US," says Stephen Ziff, a partner at Coller Capital. "I suspect that's encouraged institutions that were perhaps thinking about disposing of private equity assets to defer that decision a little bit."

Other factors contributing to the lack of large secondary deals include rising valuations at publicly-listed companies. "When markets go up, people defer any decisions because they're seeing liquidity," Ziff says.

There have been a limited number of large secondary sales in 2013. AlpInvest Partners recently purchased up to €800m of private equity assets from HypoVereinsbank, the German subsidiary of Italian bank UniCredit. Lexington Partners also reportedly purchased a $648 million portfolio of private equity fund interests from Assicurazioni Generali in July.

However, in general this end of the market has been quiet, which raises the question: how will big-ticket secondary investors be impacted?

"Secondary buyers managing very large funds rely on big portfolio transactions to put money [to] work," says Philipp Schnyder, managing director and co-head of private equity secondaries at Partners Group.

Miller: *big deals are coming back*

> ***There is no pressure right now to do a deal. There's no liquidity issue and for most limited partners there's not an allocation issue***
>
> **Todd Miller**

"The lack of such transactions, if this continues, might represent a major hurdle to their strategy and positioning."

New regulatory regimes (including Basel III in Europe and the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US) fuelled predictions that banks would need to offload enormous volumes of private equity fund interests and direct investments on the secondary market. But significant uncertainty remains about when financial institutions will need to comply fully with new regulations. »

> ***If you talk to all the buyers, everybody's working on $100m to $300m fund restructurings***
>
> **Ian Charles**

Charles: *the mix is changing*

» US banks have until July 2014 to comply fully with Dodd Frank. Final rules for Basel III are scheduled to go into effect between 2015 and 2018, although an exact timetable is difficult to quantify given the various possible extensions.

"Some groups are still waiting to see final regulations," says Todd Miller, managing director at Cogent. "There is no pressure right now to do a deal. There's no liquidity issue and for most limited partners there's not an allocation issue. It's really just a clean-up and [portfolio] management issue."

A CHANGING MIX

One relatively recent development in the secondaries market is the increasing extent to which general partners are using secondaries to restructure funds that have reached the end of their contractual lives.

"If you talk to all the buyers, everybody's working on $100 million to $300 million fund restructurings, and nobody was doing those two years ago, so the mix is changing," says Ian Charles, partner at Landmark Partners.

"About a third of last year's volume was in transactions that were over $750 million, so if that contracts by half, you lose $4 billion of large portfolio trades. We believe there will be at least $2 billion to $3 billion of fund restructuring trades this year to make up that gap."

Despite the lull in secondary deals during the first half of 2013, there are a number of reasons to expect a rebound in activity during the last six months of the year. For one, secondary activity has historically been more prevalent during the third and fourth quarter.

"Most people come to the market in the fall," says Hugh Perloff, managing director with Portfolio Advisors.

Canada's Public Sector Pension Investment Board, which oversees about C$76 billion in total assets, is in the process of shopping a private equity portfolio of around eight funds valued at about $1 billion, according to four secondary market sources. The portfolio is being brokered by Cogent Partners, the sources said, though Cogent declined to comment on the situation.

"Intermediaries have been very busy educating potential sellers and pitching for transactions over the past nine months, which may trigger an increased supply of large transactions in the second half," says Partners Group's Schnyder. "However, such a resurgence would also depend on a return of volatility to the market and on whether portfolio distributions slow down. In a period of volatility, when valuations are fluctuating, then I think that would encourage people to pursue [secondary] sales."

STILL A NEED

Even with higher volatility in the second half of the year, it is unlikely that total deal volume for 2013 will recover sufficiently to match the record $25 billion of deal flow of 2012.

Nonetheless, many secondary market participants are gearing up for increased activity in the coming months. "Our own pipeline looks very robust for the second half," says Landmark's Charles.

Perhaps the most telling statistic pertaining to future secondary activity is the estimated $70 billion of combined net asset values that financial institutions will, at some point, have to part ways with. "There are still a lot of big portfolios that need to be sold," Charles says.

Equally on the buy side, while most secondaries investors are targeting small to medium-sized transactions, large groups such as sovereign wealth funds need to put money to work in much larger amounts.

"They're not going to buy $100 million or $200 million portfolios," says Cogent's Miller. "They want to do the big deals."

At press time, activity was already showing signs of a rebound. "In the last few weeks, it has gotten materially busier," Miller says. "I think you'll see a much busier second half of the year than the first half."

And those billion dollar portfolio sales? "I think they're coming back." ■

DEAL STRUCTURING

Sophisticated secondaries

As valuations in the secondary market have risen in recent months, buyers are considering more complex deals and innovative structures to enhance their returns, writes Yolanda Bobeldijk

With robust pricing and more than $35 billion of dry powder still to invest, one would think the secondary market would be alive and kicking. However, snapping up secondaries is not as straight-forward as it was in 2011 and 2012.

For one thing, there are fewer large portfolio sales by banks than in previous years (see p. 48). The revival of the public markets has meant that some LPs have seen their private equity allocations fall in relative terms (because other assets have risen in value). With distributions up, LPs have less urgency to sell. And with NAVs on the rise, potential sellers are reluctant to offload holdings that could potentially increase in value quarter-on-quarter.

"The traditional LP secondaries have, in many instances, become somewhat commoditised", says Andrew Hawkins, founder and chief executive of NewGlobe Capital. "It's very competitive: people are paying par or close to par for the top assets and the returns are probably not going to be as good as they have been historically."

Hawkins: *prices go up, returns go down*

As a result, says Hawkins, "an increasing number of secondaries firms have turned their attention to structured transactions".

This view is echoed by Bruno Bertrand-Delfau, co-head of the EMEA private equity practice at Baker & McKenzie. "To maintain high returns, the sophisticated players may focus on complex or structured transactions and avoid participating in the larger auctions that often go at a very high price," he says.

To enhance returns, many players are exploring more innovative deal structures.

> ***As pricing has strengthened coming out of the downturn, I think the use of deferred [payment] is becoming a bit more prevalent***
>
> **Joe Marks**

DEFERRED PAYMENTS

Take the New Jersey Division of Investment, for instance. In June, the pension fund agreed to sell $925 million worth of stakes in real estate funds to a partnership that included NorthStar Realty Finance, NorthStar Real Estate Income Trust and funds managed by Goldman Sachs Asset Management (GSAM).

The sale was structured to include a deferred payment, with an initial sum of $510 million being paid. It was also agreed that New Jersey would receive 15 percent for a three-year period following the closing date of each fund interest. In the fourth year after the closing of each fund interest, distributions would be divided equally between the partnership and the pension fund – and after a four-year period, the buyers would receive all distributions, after paying the final acquisition price. The deal was said to be executed near par – considerably higher than other real estate secondaries deals.

Deferred payments have become more commonplace as a financing tool to improve the headline price, especially for IRR-challenged situations, according to Philip Tsai, global head of UBS's secondary advisory group. "The concept is nothing new; it's just [that] the frequency of usage has increased," he says. "There's a growing acceptance of these structures."

"As pricing has strengthened coming out of the downturn, I think the use of deferred is becoming a bit more prevalent," agrees Joe Marks, a managing director and head of secondaries in investment management at Capital Dynamics.

THIRD PARTY LEVERAGE

Additionally, the usage of third party leverage is becoming more widespread. »

» Leverage largely disappeared from this market in 2009, but it has slowly been coming back towards the levels seen in 2006 and 2007, according to Andrew Sealey, managing partner and chief executive at Campbell Lutyens. "You might see 40 percent leverage, depending on the portfolio. In 2007 it was nearer to 50 percent," he says.

Leverage tends to "ebb and flow" depending on how robust the underlying markets are, according to David Atterbury, a partner at HarbourVest. "When there's good liquidity in the underlying private equity market, people will take a little more leverage against those near-term cash flows. When there aren't any near term distributions then the leverage in the secondary market goes down a bit."

Even deferred payments are a form of leverage, says Atterbury. "A deferral from a seller is essentially leverage, as an element of the purchase price is effectively being borrowed for a period of time. So even firms that say they don't use any leverage probably are."

TOTAL RETURN SWAP

As well as using more leverage and deferrals, other types of structured deals are on the rise as the market matures. "We are seeing more structured deals where the seller and the buyer cherry-pick which assets are going to be transferred. Therefore we are seeing more complexity in the drafting of the documentation, with often an involvement of the GP," says Bertrand-Delfau.

Further examples include transactions whereby the asset is not transferred. In this structure, called a 'total return swap', a buyer and seller agree to pay each other all the cash flows that would have been paid had a straight sale and transfer been completed, says Sealey. But while it arguably avoids some difficulties associated with transferring fund interests, the structure is "quite cumbersome and potentially tax inefficient", he says. "It can also be more expensive and leave some administrative burden and reputational and counterparty risk with the vendor."

In some of these "derivative-like transactions", returns are guaranteed on a portfolio of assets for a counterparty, according to Atterbury. This happens when a financial institution is looking to take risk of the balance sheet and doesn't need the cash flow, he adds.

"In these deals, the secondary firm guarantees them a certain level of return from their portfolio, but doesn't actually buy the assets; they stay with the seller. The owner then keeps the distributions themselves, and once those distributions have come back and paid up to the agreed level of return, then all subsequent distributions will be for the benefit of the buyer," he says.

Deals like this can potentially be effective for insurance companies trying to bypass the Solvency II legislation, Atterbury points out. "That changes the profile of the asset. The risk is no longer private equity portfolio risk, but a counterparty credit risk. It's a clever way of moving the PE risk from the balance sheet."

NEEDS MUST

The supply of situations which require some form of restructuring has increased – be they secondary directs, stapled transactions, GP restructurings, risk transfers, recapitalisations or active portfolio management by LPs, according to Mark McDonald, a director for EMEA and Asia at Credit Suisse's secondaries advisory business – which is also why complex deals are more prevalent.

Indeed, some deals can only be done by using complex structures, says Lars Thoresen, managing partner at Nordic specialist Verdane Capital. "The creativity and the understanding of the needs of the parties, as well as the introduction of elements like deferred payments or earn-outs often make it possible to complete transactions," he says.

Atterbury: *leverage ebbs and flows*

> ***A deferral from a seller is essentially leverage … So even firms that say they don't use any leverage probably are***
>
> **David Atterbury**

Yet while these sophisticated deals – including secondary directs – are becoming more common, they are harder to close, because of the higher execution risk and the need for more intensive diligence, according to Atterbury. "Some of the more complex deals can arguably offer higher returns, but [they] typically come with higher risk", says Sealey.

Nevertheless, many believe these complex, sophisticated deal structures are here to stay. "Over the next five years, you will see previously unworkable structures emerge," says McDonald.

Necessity is the mother of invention here. As Bertrand-Delfau puts it: "Because traditional secondary transactions will be scarcer, the majority of the market will have to be more imaginative." ■

CAPTIVE BROKERS

A market shake-up

Leading secondary advisor UBS lost its chief Nigel Dawn, who later joined Evercore – setting up what could be an epic battle for mandates in the rest of 2013, writes Christopher Witkowsky

Earlier this summer, Nigel Dawn, who started the secondaries advisory business at UBS, shocked many market professionals by announcing his retirement from the bank. Dawn had led the group, which had closed some of the most significant secondary sales in the business.

Weeks later, Dawn again shocked the market when it was revealed he was joining investment bank Evercore to launch a rival secondary advisory business. Adding to the drama, Evercore also said Dawn would be joined by Nicolas Lanel, another secondaries executive from UBS, who would head up the European side of its 'Private Capital Business'.

Strangely, UBS had previously announced that Lanel and Philip Tsai would replace Dawn at the helm of the secondary advisor business; it's not clear what changed.

This was a significant development. UBS has been one of the biggest players in secondary advisory work, alongside Cogent Partners (although firms like Park Hill Group, Campbell Lutyens and Houlihan Lokey have also been bolstering their capabilities in the business in recent years).

> ***We're looking to invest and grow the business … there's a strong commitment and investment that the firm has continued to make***
>
> **Philip Tsai**

Some in the market have even questioned whether it points to an underlying flaw in the captive model – i.e. whether it affords the principals appropriate compensation for the kind of business they generate. The UBS secondaries team may be one of the leaders in the business, but the revenue it generates barely "moves the needle" relative to the bank's total assets, sources point out. Some even wondered whether UBS would use Dawn's departure to get out of the business.

However, UBS seems to have answered that question emphatically. In an interview with *Private Equity International* in August, Tsai said UBS had engaged recruiters to hire additional professionals for the team.

"We're looking to invest and grow the business … there's a strong commitment and investment that the firm has continued to make and plans to make," Tsai told *Private Equity International*. "We're looking to expand our team in the US and London."

In fact, the bank has already won two "significant" mandates since Dawn's departure, Tsai said, declining to disclose details.

UBS – which is known for brokering large trades – is also starting to explore opportunities around GP restructurings and other 'non-traditional' secondary deals like those related to real estate or infrastructure fund sales.

Dawn: *on the move*

Meanwhile, Evercore seems poised to make a run at some of the private funds secondaries sales that have been long dominated by UBS and Cogent. UBS, for example, helped the New York City pension system sell about $1 billion worth of its private equity portfolio, while Cogent has worked over the years with the California Public Employees' Retirement System and Canada's Public Sector Pension Investment Board, as well as advising on the restructuring of Behrman Capital's $1.2 billion third fund.

Evercore, which set up its private placement business by recruiting the team from Lehman Brothers after that bank went bankrupt, gave Dawn and Lanel minority ownership stakes in the business. The bank was planning to launch the business in the second half of the year, as well as recruit more executives for the team.

With the secondaries market poised for a busy final few months of the year, it will be interesting to see how this race for business plays out. ■

DEAL MECHANIC: EVOCO/ NEI

Zombie repowered

Evoco's restructuring of an ailing private equity portfolio (backed by independent secondary firm Headway Capital) illustrates one way that the industry can deal with its many dysfunctional funds, writes James Taylor

In 2001, a Swiss private bank called Sarasin – then owned by Holland's Rabobank – had promoted to its clients a vehicle called New Energies Invest (NEI), raising about €90 million from institutional and private investors. A local Swiss M&A boutique called Remaco was brought in as investment advisor, and NEI set about building a portfolio of mostly minority venture and growth capital stakes in renewable energy companies.

Initially, everything went pretty well. But in the aftermath of the financial crisis, amid a difficult period for the renewable energy industry, performance went backwards. By 2011, the vehicle was basically a lame duck: some of the six remaining businesses in the portfolio were in urgent need of restructuring and/or refinancing, but the vehicle was fully invested and so had no way of injecting extra capital. NEI had not yet distributed any capital to its investors (any proceeds had been used to make new investments and cover the management fee), and market conditions made it particularly difficult to exit these ailing companies. In addition, many of the original team were no longer with the advisor.

Enter Evoco, a relatively new group founded by Felix Ackermann and Michel Galeazzi, who had previously worked together at 3i Group (before the latter moved onto HgCapital for three years). Evoco specialises in taking over and restructuring ailing funds, injecting capital as required and managing out the portfolio in a way that delivers liquidity for existing LPs.

Having come across NEI, it got in touch with the management team and persuaded them that a fundamental restructuring was required. In practice, this meant pulling the plug on the existing vehicle and transferring the portfolio to a new closed-end Jersey-domiciled limited partnership, with Evoco acting as the new GP. The financial backing for this €20 million transaction was provided by Headway Capital, a UK-based secondaries firm that specialises in small and complex deals like this.

Since the deal closed in the third quarter of last year, Evoco has largely focused on restructuring the portfolio companies (which, it admits, took longer than expected due to the ongoing woes of the underlying market). However, it's now starting to move into harvesting mode; indeed, it has already started distributing capital to LPs, thanks to a partial divestment.

It's planning to exit all the assets within three years, so it will be a while before the merits of the deal can be assessed fully. Nonetheless, it does seem to be heading in the right direction – and it does seem to illustrate three of the key aspects necessary for a restructuring like this to work.

> ***The fund was fully invested and the companies needed money – so it was clear that a deal had to be done***

Solar power: *a key focus of the NEI portfolio*

1 A SITUATION THAT DEMANDS ACTION

One of the biggest problems in dealing with ailing funds is inertia: GPs have little incentive to move the process along, as long as they're continuing to pick up the management fee; and while LPs »

» may be dissatisfied with the situation, there's often no particular impetus forcing them to address it. The result is that funds limp on much longer than they ought to (and the inevitable restructuring ends up being all the more painful).

In the case of NEI, however, doing nothing was not really an option. This was a quasi-public vehicle that published its accounts annually (it had previously hoped to float one day). So the problems in the portfolio were very clearly visible to the outside world: net asset value was declining, and the vehicle's running costs were painfully high.

It was also in the interests of Sarasin find a solution that would benefit investors, many of whom were long-standing clients of the bank (NEI's chairman worked at Sarasin, as did one of the other independent directors).

Equally, changes were urgently and patently needed at asset level. "The fund was fully invested and the companies needed money – so it was clear that a deal had to be done," says Galeazzi.

Evoco: *zombie hunters*

2 AN ENGAGED AND CAPABLE SELLER

Significantly, NEI's management recognised and accepted this urgency. Ackermann admits that when Evoco first approached them, he was worried that they would be reluctant to engage – not least because they were aware of the time and effort it would require, and because the vehicle's quasi-public nature made it impossible to conduct the process behind closed doors (as LPs often like to do in a restructuring situation).

There was also a concern that they might be too hands-off. "You might have thought that they would not be very close to the situation, so they wouldn't be interested in talking to active restructuring specialists. But in fact the contrary was true: they were very professional and very aware of the issues."

Another important point was that NEI's management had the power to make change happen. As Galeazzi points out, this is not always the case with dysfunctional funds. In some cases, the LP group is too disparate or divided to act collectively; in others, they don't have sufficient resolve or clout to take on a strong-willed GP.

In this case, the fact that the principals were talking to each other directly, without an intermediary, clearly made the process much easier.

3 A DEAL STRUCTURE THAT WORKS FOR ALL CONCERNED

According to Ackermann, the first problem in negotiating the deal was agreeing on valuations. "When things turn sour, there's obviously going to be a gap between what the new GP thinks a portfolio is worth and what the existing GP thinks it's worth."

The key to resolving this, he says, was to put in place a flexible structure. Evoco would not be drawn on the details – citing confidentiality constraints – saying only that the structure allowed them to share some of the risk with existing investors (by rolling over their interests) while giving the new money a share of any upside.

There was also the related issue of negotiating an exit for the existing adviser, who ultimately received a package compensation (Evoco wouldn't say what, but in previous situations like this it has tended to be about six months of management fee).

It didn't help that the portfolio continued to be, as Galeazzi puts it, "a moving target". One of the companies even went bust in between the signing and closing of the deal, further delaying the process and eventually requiring an extra injection of capital.

On the other hand, the fact that Evoco started its portfolio management activity even before the completion date was one of the main reasons the deal was able to "get across the line", says Ackermann – because it showed the other parties involved (particularly the management teams of the operating companies) what difference an active partner could make.

These were lengthy and complex negotiations, taking over six months to complete. But since due diligence is always going to be more difficult in this sort of deal (given the number of assets and the time and access constraints), structuring becomes more important. Says Galeazzi: "Our focus is on having a structure that works when it's sunny and when it's rainy ... There were both positive and negative surprises, but the structure we had in place worked quite well to iron those out for the benefit of all concerned." ■

EURO VC

Never-ending story

LPs need to be pushing harder to realise value from venture funds that are 10-12 years old, a report suggests – which may be good news for secondaries players. By James Taylor

Earlier this year, the British Private Equity and Venture Capital Association published a report, written by two academics at the London School of Economics, which purported to bust a few myths about the European venture capital industry – particularly in terms of its perceived disadvantages to US venture. The headline finding was that if you control for entrepreneur experience, VC-backed businesses were no less likely to succeed in Europe than in the US – at least in terms of finding exits.

But there was also a chart buried away towards the back of the report that had some interesting implications for the venture secondaries market in Europe. Based on data from Dow Jones VentureSource, the chart plots the cumulative total of exits (including both IPOs and trade sales) for venture-backed businesses in the US and Europe. In amongst the statistical wonkery, what it basically shows is that in Europe, the volume of exits starts slowing noticeably about 100 months (eight years or so) after a first VC investment, has almost flattened out by 150 months (12.5 years) and has completely ground to a halt – at about 40 percent of VC-backed companies – by 200 months (16.5 years).

Since a typical limited partnership fund has a ten-year life, with possibly a couple of years of fund extensions on top of that, this might not seem very significant. However, according to Roland Dennert, a Munich-based managing partner at direct secondaries specialist Cipio Partners, there are a lot of funds raised between 1996 and 2000 (so they're now 13-17 years old) that are still around and haven't been liquidated – because there hasn't been the pressure from LPs. "LPs believe that one day the companies in these portfolios are going to be sold. But the data shows that's not going to be the case: if a company is not exited 10-12 years after its funding, the chances are that it probably won't be."

The financial crisis has exacerbated this issue, he suggests. Because it's become much harder to find attractive exits, typical VC holding periods have extended substantially (from 3.2 years in 2002 to 6.4 years in 2012, according to Cipio's own analysis of the VentureSource data).

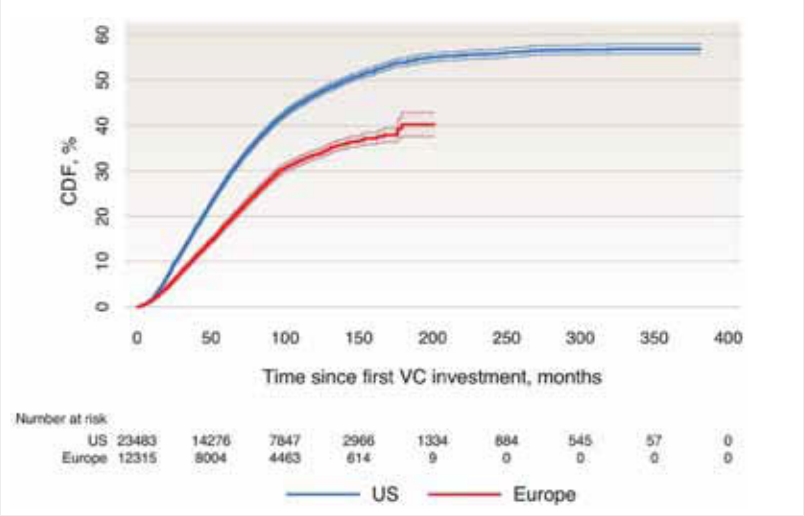
What this means, he argues, is that LPs need to start pushing harder for funds to be liquidated at the end of their statutory life (i.e. 10-12 years) – because statistically, there's unlikely to be much good news from the portfolio thereafter.

All of which ought to bode well for direct secondaries firms, who can theoretically offer these existing LPs a better chance of realising some value from a superannuated portfolio. Earlier this year, Nordic specialist Verdane Capital Partners bought a portfolio of four assets from Danish group Nordic Venture Partners. Other venture firms are also considering this sort of portfolio sale, sources say, including Amundi and BayTech Venture Capital.

Nonetheless, there remains a significant barrier to progress: the willingness of European VCs to bite the bullet (despite the fact that they can typically create more value with new deals). "If we talk to LPs, they're very much in favour," says Dennert. "But GPs are often reluctant because they see some stigma attached to doing secondary deals – it's like they're giving up on it and saying they couldn't do it themselves. New deals are happening all the time, so progressively it's getting there – but very slowly." ■

FLATTENING OUT

Most European VC exits happen within 150 months or not at all



Source: Dow Jones VentureSource

CHINA

Great expectations

Private equity dealflow continues to stall in China – but so far it hasn't yet prompted the hoped-for explosion in secondary market activity, writes Clare Burrows

Secondaries specialists have been busy in Asia lately. While firms such as LGT Capital Partners and Paul Capital have been doing secondaries deals from Hong Kong since 2007, in the last 18 months other firms such as Greenpark Capital, AlpInvest Partners and Lexington Partners have all been enhancing their Asia presence.

So far, secondary market activity in Asia has been more of a gradual flow than a wave of deals. But the changing macroeconomic conditions are increasing pressure on GPs – and that could result in more opportunities, particularly in China.

Asia's largest and most attractive market is losing some of its shine, thanks to a sustained slowdown in annual GDP growth and a frozen IPO market that has left GPs holding assets that they need to exit.

"If you could do [secondaries] at this moment – wow," says Peter Fuhrman, chairman and chief executive of China First Capital. "In this market, some LPs could sell out for 10 cents on the dollar."

"For LP secondary buyers, it is nirvana: a distressed exit market, portfolios with solid growing businesses inside of them, and a group of somewhat distressed LPs. A lot of these LPs, even bigger ones who have their money in China, have lost faith."

Jason Sambanju, managing director and co-head of Asia at Paul Capital, adds that foreign LPs are growing more prudent when looking at their Asia private equity investments. "A lot of these LPs have already done a lot of the pruning that they want in their US and European assets, and they find suddenly that they have one or two big positions in Asia. People are becoming more sober in terms of their view of the China growth story."

But the huge potential of China secondary opportunities has not yet been unlocked. In fact, completed sales of LP stakes have been scarce. As one industry source comments: "There are a few, but it is out of all proportion to the number of people and amount of money [put in]. I don't think there is any other example where productivity against spending has been so low."

PRICE/PERFORMANCE ISSUES

One of the biggest barriers to completing secondary transactions in China is pricing, industry sources widely assert.

"For [stakes] in high-quality GPs, what I'm seeing is pricing that is on par or at a small premium to par," Brooke Zhou, executive director at LGT Capital Partners, explains.

Prices can get as high as at 3 to 5 percent above the net asset value of the fund – which is expensive in the secondaries world, according to Zhou.

Fuhrman agrees that prices are too high. "The only substance to doing these deals is to buy things at a net asset discount. But what we know is that among the very few [secondary deals] that have taken place involving China GPs, some were actually bought at a premium to net asset value."

For example, in June, online portal China.com sold its interest in New Horizon Capital's fourth fund to AlpInvest Partners for $516,000 – roughly on par with its original commitment, according to a Hong Kong stock exchange filing. Following the deal, AlpInvest took over the balance of China.com's total $4 million commitment to the vehicle, the filing says.

However, LGT's Zhou says that even cheap deals aren't getting done. "For low quality GPs, even at a higher discount, the deal is sometimes difficult. Even at a 20-to-30 percent discount, people sometimes hesitate for different reasons, such

Zhou: *pricing can be expensive*

as concerns over quality of the portfolio, quality of the manager and whether the manager can raise the next fund. If they can't raise a follow-on fund, then their motivation towards the current fund, which we are purchasing, becomes questionable."

BOOTS ON THE GROUND

Concerns over fund manager quality are common in China – and as LPs pull back from investing, many GPs can't raise new vehicles, industry sources say.

Fuhrman believes that sifting through GPs is difficult for Western secondaries firms that have opened offices in Hong Kong or China over the last five years, as they don't have significant resources or local teams in China to assess the quality of portfolios.

"In the end, what you are buying can seem like a pig in a poke. If you don't have Chinese language fluency, if you don't have a comfort level of doing business in China, if you can't talk to the Chinese *lao ban* [boss] who is running that company – how can you assess the value of the companies inside a GP portfolio? As far as I know, few if any of these guys speak Chinese. And fewer still have significant experience investing in and working alongside Chinese private sector businessmen."

As a result, because many deals on offer are smaller and resource-intensive to diligence, funds with an existing (and substantial) presence on the ground are likely to benefit.

"A lot of deal flow we come across in Asia – including from China – involves smaller transactions, and we're happy to put the resources to work on the smaller deals if we find them attractive," says Adam Howarth, managing director at Partners Group. "We leverage our existing platform so even if they're smaller transactions, we're able to pursue them because we have the resources on the ground." ■

> ***For buyers, it is nirvana: a distressed exit market, portfolios with solid growing businesses inside of them, and a group of somewhat distressed LPs***
>
> **Peter Fuhrman**

REAL ESTATE

NorthStar rising

The real estate secondaries market is getting increasingly liquid – thanks largely to the emergence of some non-traditional buyers. Evelyn Lee reports

NorthStar Realty Finance, a New York-based investment firm, has come from nowhere in 2013 to emerge as one of the biggest players in the real estate secondaries market.

In February, it spent $390 million buying a 51 percent stake in a portfolio of 45 real estate fund interests previously owned by financial services organisation TIAA-CREF.

Then in June, it teamed up with Goldman Sachs Asset Management to buy up to 25 fund interests with an approximate net asset value of $925 million from the New Jersey Division of Investment pension plan. It was one of the largest real estate secondaries transactions ever completed, and included fund interests from managers such as Walton Street Capital and BlackRock, according to a source familiar with the deal.

The price paid was apparently somewhere near par, which is considerably higher than most real estate secondaries transactions. However, the deal has an unusual structure: NorthStar is paying $510 million up front, but splitting the distributions from these fund interests 85/15 with the seller for the three years after the funds close. After a four-year period, the buyers will receive 100 percent of all distributions – following payment of the remaining $415 million to New Jersey.

NEW FACES

Three or four years ago, this market was dominated by a handful of secondaries-focused firms, such as Landmark Partners and Partners Group, as well as 30 to 40 non-traditional buyers that played a lesser role.

However, in the past two to three years, the number of non-traditional buyers – hedge funds, pension plans, endowments and others that are interested in, but not dedicated to, buying real estate fund stakes – has ballooned to more than 200, one source says. And this trend looks set to be permanent, not cyclical, as potential buyers get more familiar with the secondaries market.

NorthStar is unusual even among non-traditional buyers: previously known primarily as a commercial real estate lender, the firm had no exposure to real estate funds prior to the TIAA-CREF transaction. But buying these fund interests is "an alternative, non-correlated way to get broad exposure to commercial real estate," said Daniel Altscher, an equity analyst at FBR Capital Markets, a Virginia-based investment bank that follows NorthStar. "The motivation is to diversify the cash earnings streams for this company."

The deal also allows NorthStar to capitalise as the commercial real estate market improves, Altscher suggests. He estimates that the firm acquired the interests at approximately 72 percent of what the New Jersey pension plan paid for them, thanks to falling valuations. "There is significant embedded upside to the underlying NAV as property values rise and move up toward – and perhaps beyond – the seller's original cost basis," he wrote in a research note.

He believes NorthStar is likely to do more secondaries deals like this – not least because of its partnership with Goldman Sachs, which will provide NorthStar with an additional channel for accessing deals (in both real estate and private equity).

It's possible the emergence of deep-pocketed bidders like this may force the traditional players to change the way they do business – either by bidding higher (and consequently accepting lower returns) or by getting more skilled at sourcing, underwriting and structuring deals.

On the other hand, NorthStar's acquisitions should encourage more vendor activity, as sellers see pricing improve and transactions like this become ever more commonplace. And a more active market ought to be good news for all concerned. ■

NorthStar: *rapid rise*

An earlier version of this article previously appeared in our sister title, Private Equity Real Estate (www.perenews.com)

LIQUIDITY

Highly rated

A new index may shed some more light on supply and demand in the secondary market, writes James Taylor

Just how easy is it to buy or sell a stake in a private equity or real estate fund? For years, the only way most LPs could discover the answer to this question was by engaging a broker and going to market, or calling up some trusted contacts. However, there's a new method in town, courtesy of Toronto-based Setter Capital.

Setter is a secondaries advisor that has been active in the market since 2006, and claims to now cover over 7,000 institutional investors and over 3,000 fund families – by which it means funds managed by a particular GP that have a similar strategy. The firm has used this experience to develop a global Liquidity Rating, a measure of the relative liquidity of fund interests.

The idea is that these 'fund families' are split into four categories – 'Good', 'Very Good', 'Excellent' or 'Unrated' – depending primarily on the number of likely buyers for an interest in one of the funds. That might include those who have previously registered an interest in that fund with Setter, those who have previously priced the fund, or other primary investors in the fund who are known to buy secondaries.

"We've always tracked the number of potential buyers for particular funds and fund families closely," says Setter managing director Peter McGrath. "It helps us determine who to approach on different secondary opportunities and to move quickly and efficiently."

The rating is then tweaked based on factors like the GP's openness to secondary transactions. For example, there may be 100 potential buyers for a particular fund interest, but if only 20 of those would be acceptable to the GP, then the liquidity rating will have to be adjusted down accordingly. Setter will also factor in its subjective view on the likely strength of demand in the current climate. "Part of it is subjective, because it's based on our knowledge of the buyer base," says McGrath. "There may be a lot of buyers, but we also consider how strong and serious that demand is."

One way in which Setter hopes to get its index out onto the market is via a new site called Secondary Link, which is basically a social network for secondaries buyers and sellers. As well as allowing registered users to access the Liquidity Rating for different fund families, the site also allows potential buyers to register their interest in a particular fund – and provides a mechanism for sellers to contact them (a service for which Setter will apparently not take a broker's fee). It also allows investors to collaborate on due diligence for a particular fund.

> ***If you need to sell, you know that if the fund is rated you can get out relatively easily***

THE LIQUID LIST

As an example, here's how Setter rates liquidity for a selection of Western European funds:

EXCELLENT:
Advent, Apax Partners, BC Partners, Bridgepoint, CVC, EQT, HgCapital, Nordic Capital, PAI Partners, Permira

VERY GOOD:
3i, Doughty Hanson, Exponent, Herkules, Gresham, InvestIndustrial, Montagu, Phoenix, Sovereign, Triton

GOOD:
21 Centrale, Dunedin, ECI, Equistone, Inflexion, Lyceum Capital, Palamon, Polaris, Terra Firma, Waterland

UNRATED:
Alto Partners, AnaCap, BlueGem, CapMan, GMT, L Capital, Silverfleet Capital, RJD Partners, Rutland, Zeus

It's all very much in the early stages; the site had been fully operational for less than a week at press time. But McGrath says that initial feedback has been good. "The reaction's been amazing. People are immediately saying that it's a very useful metric, for primary investing and for secondary buying. If you are considering selling a fund, you know that if the fund is 'Rated' you can get out relatively easily and there will be a lot of competitive tension. And if you want to buy a particular fund, you can see whether or not it's a fund that everyone likes. It's akin to knowing the trading volume of a listed stock." ■