Reprinted from

Debevoise & Plimpton Private Equity Report

Fall 2009 | Volume 10 | Number 1

GUEST COLUMN

State of the Private Equity Secondary Market

This article has been prepared by and is the copyright of the law firm, Debevoise & Plimpton LLP. All rights are reserved. It may not be reproduced in whole or in part without their permission. The article provides summary information only and is not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed therein.

GUEST COLUMN

State of the Private Equity Secondary Market

The private equity secondary market has received much attention over the past year. In its simplest form, the secondary market allows institutional or individual investors with existing private equity investments to sell their assets to secondary buyers. A buyer purchases these assets at an agreed upon price, typically representing a discount to current reported net asset value ("NAV"), and then assumes any remaining unfunded obligation associated with the seller's investment.

There are a variety of reasons for selling assets in the secondary market. Recently, these have included a need for liquidity, a desire to reduce future unfunded obligations, or a decision to pare back overall exposure to the private equity asset class. As the global financial crisis took hold in September 2008, many investors who were over-allocated to private equity or who needed immediate liquidity turned to the secondary market.

Over the past year, endowments and publicly-traded private equity funds were among the more active secondary sellers. In a market where financial institutions and corporations had historically been the most active, this represented a dramatic shift in the profile of institutions selling assets. In late 2008, market activity was dominated by endowments that suffered large losses across their public equity and fixed income portfolios. This led to the often-discussed "denominator effect," where an endowment's private equity holdings eclipsed its target allocation because of a shrinking overall asset base, resulting in over-exposure to private equity and forcing some of these institutions to reduce their holdings. Nearly half of the available commitments for sale that HarbourVest evaluated during the fourth quarter of 2008 were held by endowments, which had historically made up only a small fraction of the overall market.

Similarly, during the first half of 2009, nearly one-third of HarbourVest's deal flow came from publicly-traded private equity funds. In the years leading up to the credit crisis, many of these funds had employed an over-commitment strategy, relying on the expectation that a private equity portfolio could "self-fund" by utilizing the recurring distributions from one or more PE sponsors to meet the capital call requirements of other sponsors, which are typically funded over an average of ten years. As a result, these public vehicles would often over-commit their equity base in order to maximize the amount of NAV that was directly exposed to private equity versus cash or other securities reserved for future unfunded obligations. This strategy, like other forms of leverage, can succeed in a rising market with available liquidity. However, as the exit environment deteriorated, the pace of distributions slowed, and access to credit dried up, many public vehicles were forced to sell assets on the secondary market quickly and often at deep discounts to raise cash and meet funding obligations.

The financial crisis also had a marked impact on the behavior of secondary buyers. Secondary firms that had actively acquired assets prior to the crisis began scaling back amid market uncertainty and a view that trailing NAVs were (in many cases) well in excess of declining fair market values. As a consequence, secondary bids for private equity assets fell dramatically and rapidly over the second half of 2008 and first half of 2009. According to secondary market intermediary Cogent Partners, the average median bid as a percentage of NAV fell from over 90% in 2006 and 2007 to approximately 55% in the second half of 2008. Prices dropped even further in the first half of 2009, declining to approximately 36% of NAV.

This dramatic decrease in pricing led to a sharp decline in the number of completed transactions in 2009. While the dollar amount of deals evaluated by HarbourVest through the third quarter was up 15% over the same period in 2008, HarbourVest estimates that the volume of completed deals is down by over 50% from last year. This reflects the material bid-ask spread between buyers and sellers that has persisted through most of the year. Many forced sellers did complete transactions at steep discounts. However, many more potential sellers declined to sell at such distressed prices, electing to hold with a hope that pricing levels would improve.

Another key market theme over the past year has been an increase in the availability of partnership interests that

CONTINUED ON PAGE 6

While 2009 has been referred to by some observers as a "golden age" for secondaries, the level of recent activity for completed deals in the market suggests otherwise.

Guest Column (cont. from page 5)

have called little to no capital. Selling these lightly-funded interests, which are typically 0-20% called, can help investors reduce exposure to private equity and alleviate concerns about their ability to fund future commitments. Given the lack of new deal activity over the last year, many of the underlying investments within these lightly-funded portfolios were made prior to the financial crisis and at relatively high valuations. Accordingly, pricing for these interests has typically been below the average discounts seen in the broader secondary market. In some cases, buyers were offering to assume the remaining unfunded commitments while acquiring the existing NAV for no purchase price. While these opportunities can appear attractive, many traditional secondary investors have avoided them given that largely unfunded positions more closely resemble primary commitments and are often not a core part of their strategies. The buyers have instead been non-traditional, such as insurance companies, pension funds, and even some endowments. These lightly-funded secondaries often provide buyers the opportunity to increase exposure to a particular general partner in their portfolio while decreasing their average cost basis in that partnership.

While 2009 has been referred to by some observers as a “golden age” for secondaries, the level of recent activity for completed deals in the market suggests otherwise. HarbourVest believes that the market will experience an increase in completed transactions within the next several quarters as the bid-ask spread between buyers and sellers begins to narrow. This will be partly driven by renewed buyer confidence as the markets continue to stabilize and visibility on underlying company operating performance improves. A gradual acceptance of market pricing on the part of sellers should also help narrow the gap.

Ultimately, HarbourVest expects that an increase in deal activity by general partners, which in turn leads to more frequent capital calls, could serve as a catalyst for increased secondary market activity. While some investors with larger liquidity issues have sold assets over the past year, many others have held back, as the lack of funding activity has not created immediate liquidity concerns. However, many secondary buyers believe that the inevitable increase in the rate of capital calls from general partners will be the key to unlocking a flood of secondary transactions. ■

Michael J. Pugatch
HarbourVest Partners, LLC