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# Secondary market insights

An open discussion with Mathieu Dréan of Triago

When we wrote in last year's *Guide to Secondary Market Intermediaries* of a coming "secondary boom," we had not anticipated the brutal turmoil that was soon to roil global financial markets, and which has since affected all asset classes, including private equity. Since the last guide was released in June 2008, we have witnessed some of the most dramatic moves in the market's recent history.

How did the market meltdown actually impact the private equity secondary market? And after the tidal wave passes, will the secondary market emerge even stronger? Here, we address some of the questions on that topic that have come up over the past few months.

**Q** We kept hearing about a secondary market surge, but did we actually see many transactions close in 2008?

I suspect you are referring to the fourth quarter of 2008. During a strong first half of last year, the market was in fact fairly active, as the economic environment was quite different, and fund pricing was based on March 31, 2008 reports. In retrospect, it was an attractive window of opportunity for sellers. When fall came, and the full impact of the economic crisis was being felt, the market suddenly appeared flush with opportunities for buyers.

But in fact, between October 2008 and early 2009, we did actually see quite a few transactions close, although they weren't garnering much attention. The secondary market did indeed become rather hectic during the fourth quarter and, given how several of these transactions transpired, it is obvious why many of these could not ultimately be concluded. In fact, the market does not function so efficiently that assets can be thrown (in this instance, limited partnership interests) at a large number of undistinguished potential buyers with the expectation that any great result could occur.

The current environment requires sellers of secondary assets to take a selective and preferably discreet approach to deal-making, focusing on a select group of relevant buyers (which may also include non-mainstream secondary players) and to run a fine-tuned process in order to have a real chance of bringing a secondary transaction to a successful close. The key to closing the deal at the best price is maintaining the attention of these particular buyers.

**Q** You mean it's not as much of a buyers' market as we have been led to believe?

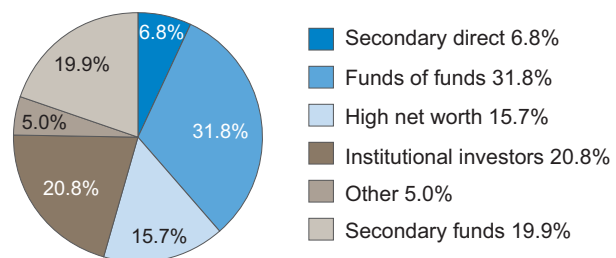
Naturally, many sellers were disappointed when they saw the gap between the prices they were being offered and the valuation of their assets. And when buyers were setting many of the prices, not many deals were being closed. The resulting market hiatus was bad for buyers and sellers alike. However, today, with Dec. 31, 2008 reports available, we believe that things should get back on track.

The main new development which contributes concretely to a more balanced market is the increased number and diversity of potential buyers, moving the secondary market well beyond established secondary specialists. In addition, over the past

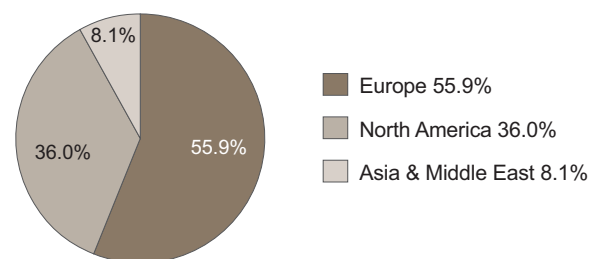
several months, a number of investors with potential allocations to secondary purchases – but who sat on the sidelines for the past two years – are now becoming active. The map of potential buyers and sellers has continued to evolve.

Illustrating the diverse range of active secondary buyers, Triago has developed a broad base of private equity investors worldwide, with each of its over 250 current buyers expressing different investment focuses, tastes and capabilities.

## Triago secondary buyer population by type



## Triago secondary buyer population by geography



**Q** Who typically are these new potential buyers?

In fact, many of the main "primary-focused" investors (institutional or private) are now actively pursuing secondary purchase opportunities, as they consider that the planets are now better aligned than they were two years ago. These traditional limited partners trust they can close on such transactions due to a greater supply of funds, including some managed by high quality general partners; a greater flexibility to access "one-off" interests (versus diversified or mixed portfolios); and an apparent return of attractive discounts.

It is fair to say that these new buyers are mainly attracted by single fund interests, including those still relatively unfunded (so-called "early secondaries" or late primaries), and are fairly GP-driven in their tastes.

Several of these groups, whether they are direct (institutional) investors or funds-of-funds managers, are shifting a good part

of their attention from primaries to secondaries. This process does not seem to be simply a function of a slower fund-raising market but rather a conscious arbitrage based on the view that the return profile of such secondary opportunities (mature or not) will very likely be stronger than those of fresh 2009 or 2010 vintage funds.

Another way for primary investors to view the current situation is that given the clear slowdown in investment activity, a number of managers who raised significant amounts of capital for their latest funds around 2007 or 2008 are likely to use their full five-year investment periods and are not likely to be back on the market raising a subsequent fund any time soon. Therefore, some of the current early secondary opportunities can be the best way to gain further exposure to GPs they like.

While some traditional secondary specialists are dismayed about these changes, other investors are rejoicing at finding “once-in-a-lifetime” opportunities.

**Q** Will this lead to much more competition with more traditional secondary buyers?

In a sense yes, although this is not really the case on the early secondaries front, where secondary specialists usually don't participate. In fact, the approach that some of these new buyers take can actually complement the sorts of deals secondary specialists pursue.

Anecdotally, one could guess that today nearly half of the main limited partners of many large secondary managers are themselves buyers of interests on the secondary market. Not that they would necessarily end up competing for the same type of deals, but this may illustrate a concrete evolution in the approach of many investors who previously focused on primaries alone.

Aside from this new breed of buyers, it is also worth noting that the universe of secondary specialists has expanded significantly, both in number, amounts under management and specific areas of focus. So there is room for decent competition, assuming – as mentioned previously – that the process is handled well and the relevant target buyers are carefully selected.

**Q** Do you think that the latest adjustments in net asset value as of Dec. 31, 2008, as reported by general partners, will help bridge the gap between buyers' offers and sellers' expectations?

It has only been a few weeks since most fourth quarter updates came out but certainly the use of Dec. 31 numbers has given buyers a much greater level of confidence in their pricing analyses.

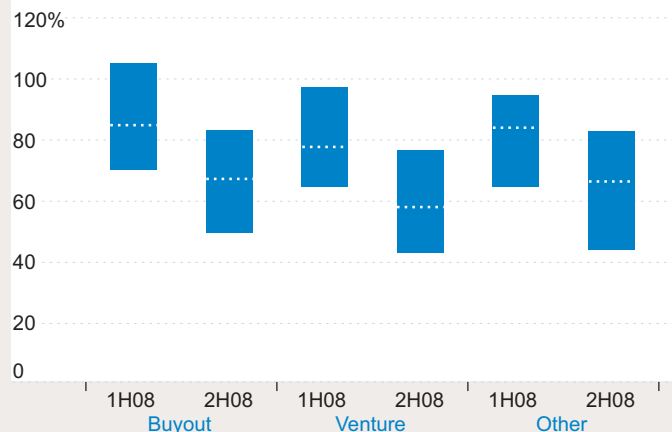
As always, the truth is that each and every situation is unique, depending on the actual underlying investments in each fund and the valuation approaches of the different GPs, which vary greatly. On a broad average, we have seen NAVs remain fairly steady from Sept. 30, 2007 to June 30, 2008 and then drop by an average 30% or so in the third and fourth quarter. Between Sept. 30, 2008 and Dec. 31, 2008, we have seen buyout fund NAVs drop by approximately 15% to 20% on average, with some peaking at negative 50%.

In retrospect, what may have sold at a discount to a June 30 or Sept. 30 reference may have ended up closer to par or at a premium to a Dec. 31 reported value.

When compiling bids received for all funds marketed by Triago during 2008, the data shows a clear difference between first half values and the second half values. On the other hand, the average bid spreads (the difference between average high prices and average low prices) remained relatively constant between the periods and in line with historical spreads of approximately 4,000 bps.

### Average secondary bid spreads in 2008, by type

A comparison of the first half of 2008 vs. second half of 2008, including median



**Q** With FASB 157 accounting rules and other valuation guidelines in place, would you say that reported values (or NAVs) are now a more accurate reflection of fair value and can provide a clear basis for secondary market pricing?

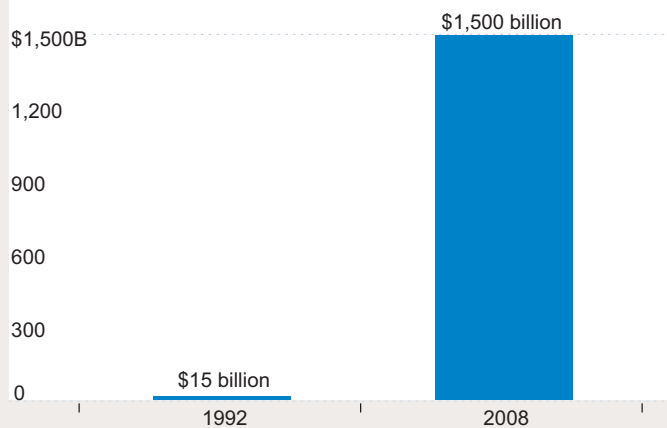
This remains a tricky question as, beyond methodologies, GPs still tend to take different approaches to valuation. As you know, FASB 157 establishes a framework requiring that investments be marked to market, but it does not explicitly articulate how investments should be valued.

Interestingly enough, at the end of 2008 and in early 2009, a factor that drove some valuations lower was the pressure that some large investors within the LP community placed on their GPs. Declining values in other asset classes quickly pushed assets like private equity, with its lag in reporting, above target allocation levels. Therefore, to cope with the denominator effect, several influential LPs insisted for investments to be heavily marked down.

In general, buyers have been doing a good job arguing for the need for steeper discounts (to cents on the dollar) in the face of supposedly inflated equity values. And of course, there has been legitimate downward pricing pressure driven by negative economic conditions. But we are fairly convinced that a bit down the road we will see quite a few substantial deals get done.

**Q** So back to the original question: In what state do you think the secondary market will emerge after the tidal wave of economic distress passes?

First of all, we need to take into account that the secondary market itself, like the whole private equity industry, remains relatively young. As illustrated by the chart that follows, in terms of absolute amount of assets under management, we've witnessed exponential growth over the last 17 years.

**Market size from 1992 to 2008**

As of early 2009, it's estimated that private equity funds managed some \$2 trillion in total assets globally. Whether we compare that to \$15 billion (in 2008) or \$25 billion (estimated for 2009) in secondary transactions per year, the secondary market still represents a very small percentage of the total size of the market.

While 2008 was not a major step up in activity from 2007, we believe that 2009 and 2010 will likely see heavier volume. Regardless of volume, the good news following this cycle is that the market will have matured, growing in size and in recognition, and will be taken into account by virtually all players managing investment programs.

While secondary transactions have become more and more common within the private equity industry, they are still far from being commoditized dealings. In turn, the secondary market still proves to be in essence a very inefficient place. For any investors seeking liquidity, having a good guide and opting to seek quality advice from an experienced and reputable specialist adviser will continue to be helpful, both to better gauge the prospects of any possible sale, as well as to leverage the market insights, wide networks and extensive transaction experience that can help execute the best deal possible.



Since its creation, Mathieu Dréan has been in charge of the operations of Triago Group's unit specializing in secondary transactions. Dréan has 12 years of industry experience, as a global fund-raising professional and secondary transactions specialist. Before joining Triago in 1998, Dréan was a sales manager in a trading company. For more information, please contact Mathieu Dréan at [md@triago.com](mailto:md@triago.com).