

Secondary Firms See New Sources Of Deal Flow By Giada Cardoletti

Ken Sawyer, founding partner of secondary firm Saints Capital, has sealed three deals this year in which hedge funds were the sellers. He expects such opportunities to increase, and he isn't alone.

With the credit markets on pause and the specter of an economic slowdown - if not a recession - looming, secondary players are expecting a boom.

"If there is a liquidity squeeze, it's no secret that improves the market for what we do," said Brent Nicklas, managing partner of big secondary firm Lexington Partners.

Some opportunities are already emerging, particularly among hedge funds and investment banks hard hit by recent problems in the lending markets. Others will show up more gradually, as the dust settles and allows the private equity industry to see the post-credit crunch landscape more clearly.

White Knights

Many hedge funds have seen big declines in the value of their portfolios in the wake of the clench in the credit markets, which began in sub-prime mortgages and ultimately spread to impact junk bonds, second-lien loans and other tools that hedge funds have been investing heavily in.

Hedge fund investors are worried about losing all their cash should the funds go under, and in some cases are demanding their cash back. To make good, hedge funds are being forced to sell whatever positions they can find buyers for.

This has implications for the private equity market because a number of hedge funds have become more active in the buyout and venture capital spheres over the last several years.

As secretive investors investing in an even more secretive asset class, hedge funds' activity in private equity is almost impossible to track accurately. While acknowledging this, Saints Capital estimates that about 2% of the overall \$1.1 trillion hedge fund market, or \$22 billion, is invested in private equity, and that 3% to 5% of that should hit the secondary market in the next couple of years.

Hedge funds have boosted their activity in a variety of ways. Some - those interested in gaining access to the debt sold by buyout firms' portfolio companies, for instance - have chosen to be limited partners. Their number includes HBK Investments, JMB Capital Partners, Tudor Investment Corp. and Seneca Capital Partners. Others have been competing or teaming up with buyout firms to do direct deals, like the purchase of Harry & David, which Highfields Capital Management bought alongside Wasserstein & Co. Others, like Pequot Capital and Maverick Capital, have carved out a niche for themselves as investors in venture-backed biotech companies.

Some of these investments are already finding their way into secondary firms' hands. A

person familiar with the situation said that Collier Capital, for example, has been in ongoing talks with troubled hedge fund Ritchie Capital to buy some of the assets from its flagship fund that were left over after the fund was sold to Reservoir Capital Group. Collier declined to comment.

Ritchie has also been deploying capital from its hedge funds into a venture capital and venture debt wing. This wing is still operational and could provide opportunities down the line.

But hedge funds aren't the only - or even the largest - source of an expected uptick in secondary deal flow. Many secondary players expect banks, which have always been cyclical investors in private equity, to begin cutting back on their involvement with the industry as the current boom comes to an end.

"There will be some balance sheet pressure with institutions that have participated in pay-to-play," said a secondary manager with a large U.S. investment bank. "These are not banks that are in trouble necessarily, but banks that have reached a limit on their strategy."

This time around, many banks are even more deeply involved than they were in the last cycle. Some have plowed lots of capital into their own and others' funds, and are already moving to dial down their exposure in those areas. Royal Bank of Scotland PLC, for example, is in the process of selling £1 billion (\$2 billion) worth of its direct private equity portfolio on the secondary market, a process that will see its private equity arm maintain control of the assets while reducing its own exposure to the deals by bringing in outside investors.

Others have co-invested heavily alongside buyout firms in deals, or have agreed to take on extremely risky 'equity bridges' in order to win buyout firms' business. Goldman Sachs Group Inc., Bear Stearns Cos. and Bank of America Corp. offered to front a \$3.5 billion equity bridge to the Blackstone Group for the \$39 billion purchase of Equity Office Properties. J.P. Morgan Chase & Co., Morgan Stanley and Citigroup Inc. are on the hook for a \$1 billion equity bridge in the \$32 billion buyout of TXU Corp., which hasn't closed yet.

As this article went to print, a number of buyout shops were successfully syndicating those equity bridges out to traditional co-investors. But two secondary players said that some of the bridges won't be able to find a home with traditional LPs, and will head instead to the secondary market.

Indeed, secondary players are wondering if co-investments made by traditional LPs might also turn out to be a sizeable source of deal flow.

"After the dot-com bubble burst, the 'tourists' that entered the venture market decided to leave, providing the first wave of direct secondaries. I think it's the same today among co-investors in buyout funds," said Sawyer.

These kinds of transactions, however, will require creativity to bring to fruition. Direct stakes in deals are harder to purchase than traditional limited partnership interests, as the rights and privileges in direct deals tend to be unique in every case. The value of

such co-investments can also be difficult to calculate, as that figure depends to a certain extent on the management fees and other items associated with the stake.

On The Horizon

Despite the attention they're paying to such near-term issues, secondary players still expect the bulk of opportunities from the credit crunch ultimately won't come from institutions like banks and hedge funds. Instead, they're looking to the private equity industry's most faithful investors: endowments, foundations and pension funds.

In the past couple of years, such investors have already begun to use the secondary market more aggressively to prune their portfolios. Some \$3 billion in deal flow came to the market this summer alone, from such investors as California Public Employees' Retirement System and the University of Texas Investment Management Co.

While limited partners' private equity portfolios aren't directly affected by the credit crunch, secondary investors expect there will eventually be some fallout for LPs. With the liquidity crunch already cutting off some avenues of exits for buyout firms, like sales to other buyout firms and dividend recapitalizations, distributions from exits to limited partners will inevitably slow. This could force LPs closer to or above their target allocations to private equity, leading them to sell some of their portfolios to make more room for new investments.

In addition, problems in the credit markets could contribute to lower returns down the road. Limited partners looking to lock in strong internal rates of return might sell into that expectation.

"The credit crunch is a catalyst," said Tjarko Hektor, a partner on Alpinvest Partners' secondary team. "Yesterday, everybody was investing in private equity with expectations of making 20% returns, two times their money and no risk. Now all of a sudden there is a complete repricing of risk. So now people are looking at their books and saying we have to get rid of some of this stuff."

Some secondary market players believe the repricing might, in fact, lead to a temporary slowdown in deal flow in their markets. Prices have been above 100% of net asset value for some time now, but increased deal flow, along with an expectation of lower returns, should bring them back down to earth.

"In the buyout space, people will quickly see things go back to discount prices," said Nicklas of Lexington Partners. "It probably won't be as great as back in 2000- 2001 but you can probably expect 10% to 20% discounts."

Sellers who have grown accustomed to getting more than 100% of the net asset value of the stakes they are disposing of may well balk, at least in the short term, if prices come down to well below those levels.

"Sellers will be hoping for yesterday's prices while, buyers will be looking at tomorrow's prices," said Andrew Sealey, managing director with secondary intermediary firm Campbell Lutyens.

But ultimately, secondary players believe sellers won't have any choice but to come

around.

"When people see that the sun is shining everyday, everybody wants to go to the beach," said Hektor. "But if it starts raining, and off people will say to themselves, 'we should probably get an umbrella.'"