GP MANAGEMENT UPDATE

LPs Aren't Only Ones Using Secondary Market More

By Marine Cole

When **Atlas Venture** decided to sell a portfolio of six companies on the secondary direct market in December 2004, it was something of a novel deal.

For most of its short history, that market – in which specialized secondary firms buy portfolios of companies from general partners – has served primarily as a refuge for investors who are fleeing the asset class. Atlas, however, was a traditional GP that had no plans to exit venture capital. It merely wanted to sell a few older portfolio investments in order to focus on younger companies.

Atlas, and others like it, turned out to be trail-blazers. Such transactions are becoming increasingly common as the secondary direct market takes on the same role for GPs that the broader secondary market is for limited partners – that of a routine portfolio management tool.

The secondary direct market got its start in the late 1990s and heated up after the Internet bubble burst, as banks, insurance companies and corporate investors like Lucent Technologies Inc. and InfoSpace Inc. liquidated their VC portfolios. But as the market grew, it eventually piqued the interest of more traditional PE investors. These investors came to the table with a different idea of how secondary direct transactions should work.

"Each GP needs to look at how to maximize returns for its LPs," said Ken Sawyer, managing director with **Saints Capital**, which buys both VC-backed and buyout-backed companies on the secondary market. "The best GPs understand their core competencies. By selling old investments, you can focus more on a new one."

The secondary direct market is particularly attractive to GPs whose funds are nearing the end of their 10-year lives but still contain viable companies. "If you've got a portfolio of private companies with limited upside, you don't just want to abandon them," said Jonathan Axelrod, partner with law firm Wilson Sonsini Goodrich & Rosati.

In years past, GPs would have had to choose between two equally unattractive options: getting an extension on the fund's life from reluctant LPs, or distributing private, illiquid company stock to investors. The secondary direct market route is a third, and often better, option, giving LPs liquidity, GPs the opportunity to better allocate their resources and portfolio companies a new lease on life.

In one recent deal, secondary direct firm **Industry Ventures LLC** acquired a portfolio of companies from a fund that was raised in 1996 by an undisclosed GP. "It was successful, but they needed a way to wind it down," said Industry Ventures Principal Hans Swildens.

Younger funds are also looking at the market. Perhaps, as in the case of Atlas, they are early-stage investors and several of their portfolio companies have reached later stages and need different expertise. Perhaps some of the companies' growth potential is limited, and the fund simply wants to sell them sooner rather than later to focus on its most promising assets and maintain its internal rate of return. Or perhaps the fund is changing strategy, as was the case with hedge fund Bowman Capital, which sold its VC portfolio to Industry Ventures in 2003 because it was shifting to investing in public equities.

The secondary direct market is likely to continue growing, as all the money pouring into the asset class means more funds will have to figure out some sort of an exit eventually and generate new funds.

"There are firms that have grown in size," said Saints' Sawyer. "And the fund-raising cycle has shortened." ●

Some Secondary Direct Snafus

These are some issues to consider before embarking on a secondary direct sale:

» The sale of partial portfolios can be complicated. It reduces management fees for the selling general partner, and forces GPs and limited partners to address how much money each should get.

» Valuation can be tricky for buyers, who rarely have access to sensitive company-level data and typically value portfolios based on the industry, the companies' ages, their funding levels, their management teams and other factors.

» Picking a buyer can be harder than it looks. Although the sellers will no longer have a stake in the company, their reputations are still on the line, and so they should make sure they pick buyers with whom they are comfortable.

Source: Private Equity Analyst