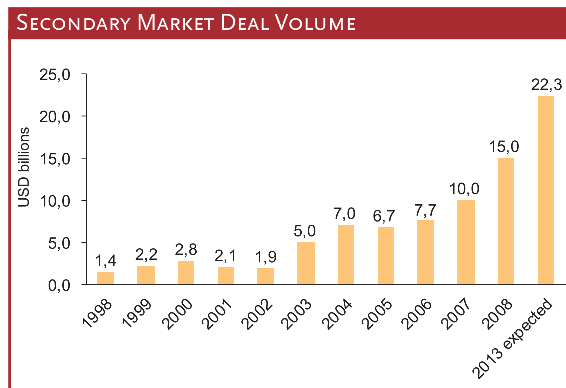
More Transactions in Almost Every Segment

The Development of the Secondary Private Equity Market

The secondary private equity market is one of the fastest growing segments in the world of financial investing. This is true for both the acquisition of Limited Partner (LP) stakes and the direct acquisition of entire portfolios. The industry has only started to develop in recent years and most industry experts believe that its growth will accelerate over the years to come. This article provides an overview of the secondary market and the different types of secondary transactions, the development of this market in recent years and a brief outlook for the future. The focus is on the sale of venture capital portfolios and how transactions in this segment differ from standard M&A transactions regarding processes, pricing and structure.

Secondary Market Deal Volume



Sources: Private Equity Analyst, Venture Economics and Auda estimates

The secondary market

Like most innovative investment approaches, the secondary market for private equity interests has its roots in the USA. As long ago as 1982, Dayton Carr founded the Venture Capital Fund of America, the first fund to acquire interests in venture capital funds and other private equity vehicles in the secondary market. Other firms with a similar focus were established in the late 1980s and early 1990s. Some of those firms, such as Adam Street Partners (USA), Arcis (France), Coller Capital (UK), Landmark Partners (USA) and Lexington Partners (USA), are still amongst the most relevant players in this market today.

One could call the founders of those firms visionaries, since the secondary market was a very small market in both absolute and relative terms until the late 1990s. Secondary funds raised worldwide totalled USD 3.6 billion from 1991 to 1997. However, from 1998 to 2002, global fundraising for the secondary market totalled USD 16.8 billion, growing to USD 44.3 billion from 2003 to 2007. After the dot-com crash the market started to explode. In 2007 alone, more then USD 13.7 billion was raised for secondary funds. At the same time, the secondary deal volume has also increased significantly, almost in line with the amount of funds raised. Total deal volume from 2002 to 2007 was USD 38.3 billion.

Today, there are many funds with several billion Euros available for secondary transactions, including AlpInvest Partners, Coller Capital, HarbourVest Partners, Lexington Partners or Paul Capital, to name just a few (for a detailed list see page 10). Within this industry, certain niches have developed: fund-of-fund investments, real estate fund investments, investments in LP stakes, and investments in corporate venture portfolios or direct portfolios. This article focuses on the latter segment: the secondary venture capital portfolio market.

The German market in this segment has so far been dominated by local investors acting as general partners, such as Beaufort Capital, Cipio Partners, HeidelbergCapital, smac Partners or Triginta Capital. However, international players are increasingly trying to enter the German market. Leading international investors include DFJEsprit, Industry Ventures, Omega Partners, Saints Capital, Tempo Capital, Verdane Capital or W Capital.

Types of secondary VC transactions

In general, there are two types of venture capital portfolio: venture capital portfolios with a general partner (GP)/limited partner (LP) structure and corporate venture capital portfolios. The vast majority of venture capital firms have a GP/LP structure. In principle, general partners manage the fund and its investments.

Examples of Secondary Direct Transactions in Germany

VC Portfolio	Seller	Buyer	No. of Investments	Year
Part of 3i Portfolio	3i Group	Heidelberg Capital / Auda	21	2008
SVC Communications Fund	Siemens	Cipio Partners	not disclosed	2007
Berlin Capital Fund	Landesbank Berlin	Triginta Capital	14	2007
Siemens Mobile Accelerator	Siemens	smac partners / Tempo	25	2006
Infineon Ventures	Infineon Technologies	Cipio Partners	30	2005
West Steag Partners	RAG / West LB	Cipio Partners	7	2005
DaimlerChrysler Ventures	Daimler Chrysler	Cipio Partners	7	2004
T-Venture Assets	T-Venture / Deutsche Telekom	Cipio Partners	15	2004

Source: Mummert & Company

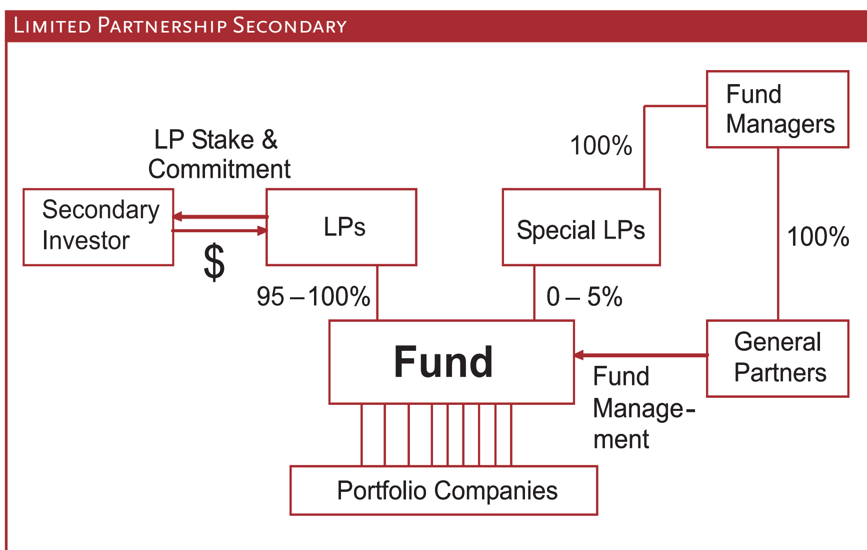
Limited partners provide the necessary funding for the fund. While the LPs in such funds are mostly based in the US, the GPs are usually based in the region where the investments will be made. The leading venture capital firms with such a structure in the German market are Wellington Partners, TVM Capital, Neuhaus Partners, Earlybird Ventures and Target Partners. In a typical secondary transaction, a limited partner would sell both his existing investments in the fund as well as all future commitments to the fund to a secondary investor.

From the late 1990s onwards, many large corporations and financial institutions set up their own venture capital divisions. Those efforts were both strategically and financially motivated. Via those venture capital arms, corporations wanted to access state-of-the-art technology relevant to their core business. It was important to have a fast-paced, flexible investment vehicle. Those corporate venture capital divisions enabled large corporations to co-invest with traditional venture capitalists, which had access to the best technology companies. Some corporations were also intrigued by the high returns that top VC-Funds achieved in the late 1990s, in particular in the USA. In most cases, those divisions were set up as 100% subsidiaries. In a very small number of cases, third party investors or the management of those special purpose vehicles (SPVs) had the opportunity to invest and hold shares in these SPVs. The majority of secondary transactions in Germany involved such corporate venture capital portfolios. Those transactions are typically called Secondary Direct Investments.

Pricing of secondary transactions

Potential buyers calculate the price of a portfolio based on an expected return (IRR) on their investment, taking into consideration the expected exit values of the portfolio stakes acquired. Typically, investors would run different exit scenarios for each portfolio stake. Those scenarios include a potential liquidation or low-return sale of a shareholding, in which case the fund's liquidation preferences in each shareholding are of major importance. Those exit scenarios also reflect different time lines until exit: The faster the exit, the higher the IRR (assuming an identical valuation).

In addition to the sum of all exit proceeds, investors will consider additional financing needs for the portfolio and the cost of managing the portfolio. Once investors discount all relevant cash flows with their respective IRR expectations, they can calculate the purchase price they are willing to pay for the portfolio. Since those IRR expectations are usually rather high, due to the inherent risk of the asset class venture capital, the discounts on the book value and the invested capital for venture capital portfolios can be significant. Usually, investors expect to triple their



Source: Mummert & Company

investment by the end of their investment lifecycle, which is approximately four years.

Development of the secondary market

From its early days until the mid-2000s, the secondary market has not been a very developed market. The number of buyers was relatively low compared to the number of assets available. Therefore, until 2003/2004 most assets sold in the secondary market traded at a major discount to both book value and invested capital. In some cases, those discounts were as high as 80%.

From 2002 to 2008, more and more secondary funds were raised. Not only did the number of funds increase significantly, but more importantly, the size of certain funds reached levels unseen before. As outlined above, several investors raised funds worth billions of dollars. At the same time, exit markets improved as stock markets had recovered from the dot-com crash and strategic buyers were actively consolidating their respective markets, increasingly buying venture-funded businesses with leading technology. The increase in the demand and decrease in the supply of secondary venture capital portfolios led to rising prices for secondary portfolios during that period. High valuations were further supported by the expectation of high exit proceeds, based on the strong and rising stock markets and exit-multiples in that period.

All that changed with the financial crisis in 2008: Discounts on book value for secondary transactions have been rising throughout the year because the supply of assets increased rapidly and the expected exit proceeds have fallen to multi-year lows. In many cases however, investors holding stakes in venture portfolios have not yet adjusted their book values to the new circumstances. Accordingly, market participants know of secondary transactions that have traded at a >75% discount from book value.

Why should sellers sell?

Given these large discounts to book value, one may ask why investors would sell their commitments. There are quite a few motivations for investors to do so. In some cases, investors have a strong need for cash. Their venture capital activities may only be a minor part of their overall business activities. This is true for both corporate as well as financial investors. For such investors it could be the right decision to deploy capital in other areas that are more central to their business. With the ▶

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WHY SHOULD SELLERS SELL?

Cash Generation	Strategic decision to deploy cash differently
Dilution Risk	Investors who are not willing / able to invest further will suffer from serious dilution
Cost Reduction	Managing a portfolio may incur significant internal and external cost
Confidentiality	Divestment in one, confidential transaction versus gradual exit
Balance Sheet Risks	Reduce capital reserve requirements

Source: Mummert & Company

sale of all investments in one transaction, this capital redeployment can be realised much more quickly.

One major risk for investors is their commitment to further capital contributions. Those commitments can be significant in size. And even if such commitments do not exist on the basis of contractual terms, they are still a major issue. In the current market environment, portfolio companies – and in particular venture capital-backed firms that are not yet profitable – may need more funding to reach profitability than initially calculated. If an investor is not able or not willing to participate in future financing rounds, his shareholding in those companies will be diluted significantly and other investors might get liquidation preferences or other rights that further reduce the value of the investor's shareholding.

Investors also refocus management resources. If venture capital investments are no longer considered a core business, the management teams of those venture capital activities will look for other career opportunities in the market. This may leave an investor without a management team working with his portfolio. Last but not least, some funds are forced to act, as the lifetime of the fund nears its end. The sale of all the remaining assets in a secondary transaction can therefore be the economically best solution for all stakeholders.

Why are secondary M&A-processes special?

The secondary market in Germany is a very young market segment. It started to develop in 2002, when the first corporate venture portfolios were sold. So far, less then a dozen venture capital portfolio transactions have been completed in the German market. The sellers were mostly large corporations or financial institutions such as Daimler, WestLB, RAG, Siemens, Deutsche Telekom, Infineon or Landesbank Berlin. Accordingly, only a few legal and corporate finance advisors, either in Germany or abroad, have the expertise to execute such processes. Regardless of whether a portfolio is sold in the form of an SPV or as a single asset deal, such transactions are very different from a standard M&A transaction. The parties involved must have a deep understanding of the relevant contractual and economic framework, i.e. the investment history and business prospects of the venture-funded businesses that are part of the portfolio.

Liquidation preferences, pre-emption rights, tag-along/drag-along rights, rights of first refusal, etc. are major value drivers in such processes and have to be thoroughly analyzed and understood by the seller and their advisors. Also, the sellers and their advisors have to be capable of understanding and valuing technology companies, in many cases both high tech and biotech/life sciences firms.

Unlike standard M&A transactions, all potential buyers of secondary transactions are financial investors. They are professionals with broad experience in secondary transactions, unlike the sellers, who have usually never completed a secondary transaction before. A seller can only prepare the transaction professionally and negotiate with such buyers on equal grounds if their deal team has secondary transaction experience comparable to that of the respective buyers.

The deal team must also know which data is relevant to the ability of the buyer to be able to evaluate the portfolio, and the type of data which can be made available to a buyer within the given legal framework. For example, sellers are usually only able to disclose the information that they have received as a shareholder, but not the information they received as a supervisory board member. Sellers cannot force the management of a portfolio company to cooperate during the sale of the fund. However, such involvement may be crucial to maximise value from the transaction. Experienced advisors can prepare the right arguments for such discussions. Knowing how to get all the pieces together and knowing how buyers value a portfolio in a secondary transaction is necessary for a successful secondary process.

Outlook

In the race for ever higher returns, some investors have overexposed themselves to private equity, hedge fund and venture capital commitments. Those commitments will be offered in the secondary market at an increasing rate in the near future. At the moment, the gap

between the book value of the assets for sale and the price that secondary investors are willing to pay is in many cases quite high. With the adjustment of book values in the latest financial statements, this gap will become smaller. As a consequence, the number of secondary transactions in almost all asset classes is expected to increase significantly in the very near future. There are already many secondary transactions in the market and there are many more to come. Sellers are either forced to sell or do so for strategic reasons. And many buyers are waiting for such transactions with their pockets full of money. Over both short and medium term, the secondary segment can be expected to be one of the most vibrant and active segments in the private equity industry. ■

About the Author

Harald Maehrle is Managing Partner at Mummert & Company. The company, with offices in Munich, Vienna and Princeton, specialises in providing advisory services for mergers and acquisitions, capital raising and restructuring. Mummert & Company is the leading corporate finance advisor in Germany for secondary, high tech and life sciences transactions.

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