VentureCapital Magazin

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Magazine for Investors and Entrepreneurs

SPECIAL

Secondary Transactions

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Editorial

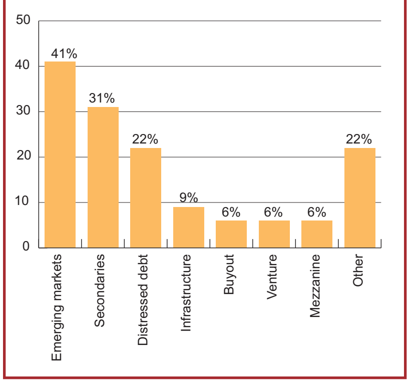
Low risk – high return

Times like those we are currently experiencing painfully remind investors that return expectations above the so called “risk-free rate” are indeed associated with a corresponding level of risk. In the short-run, however, misallocations and exaggerations in particular market segments are resulting in enormous opportunities in other parts of the financial market.

Andreas Uhde, Editor-in-Chief

One of the highly attractive parts of the private equity universe is the secondary market: Investors all around the world are craving liquidity, and financially strong buyers are ready to fulfil their desire. Yet they can afford to lie in wait. While average discounts on net asset value have most likely surpassed the 40% mark (see also page 15 of this special edition), secondary buyers are still cherry-picking. Nevertheless, once the uncertainty surrounding the real constitution of private equity portfolios recedes, the shopping spree is going to commence.

Areas of Interest for Private Equity Investments in 2009



Source: Limited Partner survey by Preqin Ltd.

For this special edition we spoke to active investors in the secondary market (Cf. pages 11-13, 18-21, 24-25), took a look at one of the largest European players (Cf. pages 26-27) and covered the Munich Venture Forum on secondary transactions (Cf. pages 14-17). The bottom line: Never before has the risk-return profile for secondaries been as attractive as in today’s environment.

However, as more and more money is pouring into secondary funds (see adjacent chart) it might pay off to act rather soon. Exceptional returns have always been a temporary phenomenon. ■

Andreas Uhde

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Note to our readers:
Since secondaries are a truly international business, we have decided to publish this special in English.

Content

3 Editorial

Introduction

5 **More Transactions in Almost Every Segment**
The Development of the Secondary Private Equity Market

10 **Leading Players in Secondary Private Equity**

11 **“The variety of potential sellers has become surprisingly well spread”**
Interview with Timothy Brody, Managing Director at Auda Private Equity

Munich Venture Forum

14 **In Step with the Private Equity Zeitgeist**
The Munich Venture Forum “Secondary Transactions”

16 **“The Seller is basically your bank”**
Extracts of the panel discussion “Secondary Transactions – Opportunities and Challenges”

Secondary Direct

18 **“Corporations and financial institutions are very good transaction partners”**
Interview with Werner Dreesbach, Cipio Partners

22 **Be Prepared for Challenges and Opportunities!**
Legal Aspects of Secondary Transactions

24 **Getting Involved**
After Buying a Venture Portfolio from 3i in 2007 and 2008, Heidelberg-Capital Is Looking for New Investment Opportunities

25 Follow-up with Prof Dr Martin Weiblen and Dr Clemens Doppler, Managing Directors of HeidelbergCapital Asset Management GmbH

LP Secondary

26 **Global Investments, The European Way**
Axa Private Equity

28 **Substantial Opportunities in 2009**
Secondary Private Equity – A Mainstream Move

30 **“Nobody is moving”**
Interview with Amos Veith, P+P Pöllath + Partners

Glossary:

• **Secondary Transaction:** The sale of a portfolio of direct investments or stakes in a venture capital or private equity limited partnership by an original investor to a secondary buyer. Reasons for a secondary transaction include: the need for liquidity, the need to re-focus resources or to re-balance portfolios between different asset classes or simply to lock-in returns
• **Secondary Direct:** The sale of a captive portfolio of private equity direct investments to a secondary buyer.
• **LP Secondary:** The sale of private equity fund stakes (limited partnership interests) to a secondary buyer.

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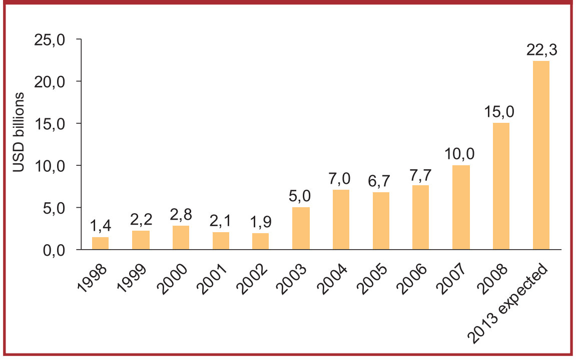
More Transactions in Almost Every Segment

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.

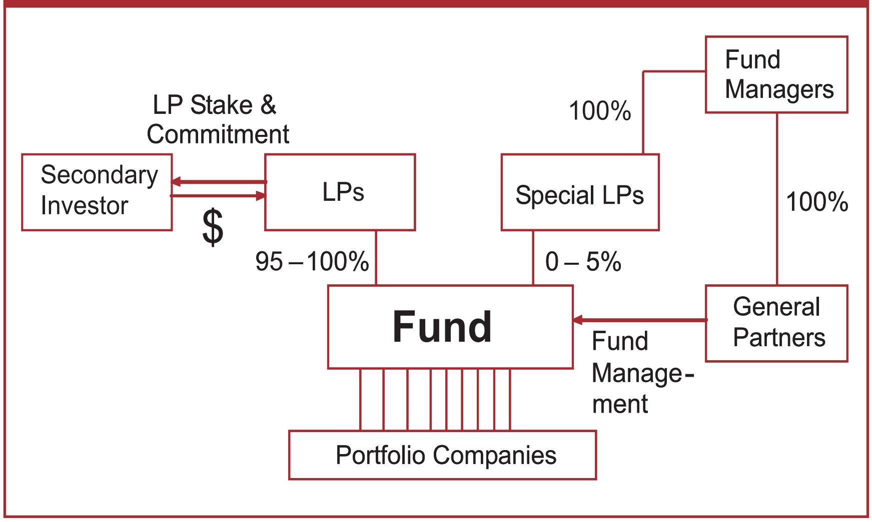
From the late 1990s onwards, many large corporations and financial institutions set up their own venture capital divisions. Those efforts were both strategically and financially motivated. Via those venture capital arms, corporations wanted to access state-of-the-art technology relevant to their core 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

Limited Partnership Secondary



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

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.

Leading Players in Secondary Private Equity

Largest Investors

Management firm	Website	Headquarters	Worth mentioning	Secondary funds under management
AlpInvest Partners	www.alpinvest.com	Amsterdam, The Netherlands	Transaction value from EUR 1 million up to EUR 1 billion	more than EUR 2 billion
Axa Private Equity	www.axaprivateequity.com	Paris, France	Separate vehicles dedicated to early secondaries (less than 50% funded)	more than EUR 5 billion
Coller Capital	www.collercapital.com	London, England	At USD 4.8 billion Coller Capital V is the world's largest secondaries fund	about USD 8 billion
Credit Suisse Strategic Partners	www.credit-suisse.com	New York, USA	Separate USD 0.3 billion vehicle dedicated to venture secondaries	more than USD 6 billion
Goldman Sachs Private Equity Group	www.goldmansachs.com/gsam	New York, USA	Fundraising for GS Vintage Fund V with a target size of USD 5 billion	more than USD 8 billion
Greenpark Capital	www.greenparkcapital.com	London, England	Focus on mid-sized European transactions	more than USD 1.3 billion
HarbourVest Partners	www.harbourvest.com	Boston, USA	Invests in secondaries since 1986	more than USD 5 billion
Landmark Partners	www.landmarkpartners.com	Simsbury, USA	Pursues also real estate secondaries	more than USD 4 billion
Lexington Partners	www.lexingtonpartners.com	New York, USA	More than 200 limited partners from 25 countries	more than USD 8 billion
Pantheon Ventures	www.pantheonventures.com	London, England	Fundraising for Secondary fund IV with a target size of EUR 4 billion	more than USD 6 billion
Paul Capital	www.paulcap.com	San Francisco, USA	Regional representative based in Munich (Peter Doll)	more than USD 4 billion

Source: own research

Dedicated to Secondary Direct Transactions

Management firm	Website	Headquarters	Worth mentioning	Secondary assets under management
Cipio Partners	www.cipiopartners.com	Munich, Germany	Fundraising for EUR 200 million fund, focus on venture capital	more than EUR 300 million
Saints Capital	www.saintsvc.com	San Francisco, USA	Transaction value from USD 5 million to upwards of USD 200 million	more than USD 1.5 billion
Vision Capital	www.visioncapital.com	London, England	Closed Vision Capital Partners VII LP in February 2009 at EUR 680 million	more than EUR 1.5 billion
W Capital Partners	www.wcapgroup.com	New York, USA	Transaction value from USD 5 million to USD 250 million, focus on USA	more than USD 1 billion

Source: own research

“The variety of potential sellers has become surprisingly well spread”

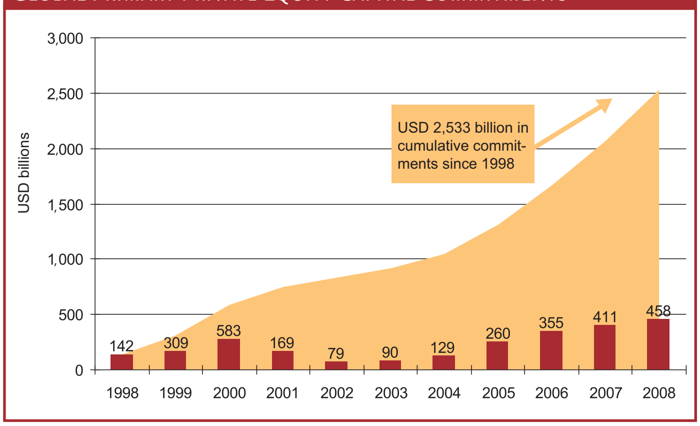
Interview with Timothy Brody, Managing Director at Auda Private Equity

Timothy Brody has been focusing on the secondary market for almost a decade. Never before has he seen opportunities as abundant as in the disrupted current market environment. As head of global secondary market activities at Auda Private Equity, which manages approximately USD 4 billion in private equity commitments, Brody’s view is based on excellent insight into the market. During his visit to the BAI Alternative Investors Conference in Frankfurt he shared some of his knowledge on the secondary market with Andreas Uhde, editor-in-chief of VentureCapital Magazin.

Timothy Brody

VC Magazin: What are the most important things that an institutional investor needs to understand before committing to a secondary fund-of-funds?
Brody: Secondary private equity funds provide several fundamental benefits for institutional investors. For a young private equity programme in particular, secondary funds offer immediate asset diversification in terms of underlying portfolio companies, managers and vintage years. Although distribution activity has slowed measurably in the current environment, secondary funds also typically offer a quicker flow back of capital than investments in private equity funds on a primary basis. Portfolios that we look to acquire are on average four to six years old. Since private equity funds have a standard structure of five years of investment, five years of harvesting and then one or two extension periods to clean up the portfolio, buying into a fund between years four and six gets you immediately into the harvest period. So the average duration of a secondary portfolio should theoretically be shorter than that of a pure primary fund portfolio. Secondary investors also escape paying several years worth of management fees, and avoid any early portfolio losses. As a result, secondary funds will tend to mitigate the J-curve effect. Lastly, and I think this is most important in the current environment: secondary funds offer the possibility of buying into private equity portfolios at a discount.

GLOBAL PRIMARY PRIVATE EQUITY CAPITAL COMMITMENTS



Source: Venture Economics

VC Magazin: According to your figures about 70% of the USD 1 billion in secondary

market deal flow that Auda saw in December last year came from sellers you characterised as distressed. As AIG put up its whole portfolio for sale this figure might increase even further. What are the consequences for the secondary market?
Brody: Clearly a significant number of holders of private equity portfolios are experiencing some form of financial distress at the moment. This triggers attractive opportunities for buyers. However, there is also currently a significant spread between what buyers want to pay for private equity assets and the prices sellers are willing to accept. There is a lot of secondary supply, but getting deals closed is difficult. We believe this spread will diminish over the balance of 2009 and more deals will begin to actually close. In terms of deal types, opportunities are coming up across the spectrum. For example, we are seeing funds-of-funds that pursued over-commitment strategies and currently do not have sufficient distributions to fund these strategies; there are family offices that overextended themselves into private equity; and a number of university endowments, which historically have used the secondary market only as a portfolio management tool, have become over-allocated to the asset class and are seeking liquidity. Some of these universities created additional difficulties by funding a significant portion of their operating budgets with endowments that are heavily weighted toward illiquid asset classes.

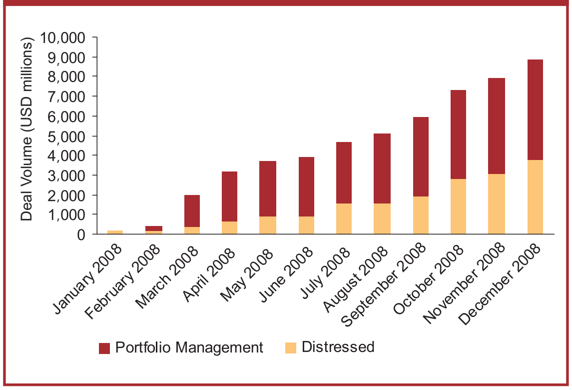
VC Magazin: Will this growth last or is the boom of the secondary market a phenomenon related to the current crisis?
Brody: We believe that the secondary market will remain robust even past the current crisis. The key factor driving secondary volume is simply the amount of primary capital committed to private equity funds – mainly buyout, venture capital, growth capital and mezzanine funds – which totalled approximately USD 2.5 trillion over the last ten years. Some percentage of that amount will eventually become a secondary opportunity. We call this the turnover rate. Given the huge base of primary capital in the ground, the turnover rate doesn't have to be very high to create a very large secondary market.

VC Magazin: Can secondary buyers push really hard for discounts with endowments and similar sellers when they want to have a continuing relationship with them?
Brody: I think the essential question to ask is: What constitutes fair value? There is a fundamental difference between fair value and a price that seeks to extract excess value. But the disconnect between buyers and sellers right now has little to do with buyers trying to extract excess value; the large bid-ask spread, in my view, is almost entirely a function of the vast differences in opinion about what constitutes fair value.

VC Magazin: What is your preferred range of deal sizes in the secondary market?
Brody: We have a niche strategy. We think the most attractive opportunities are in the small to mid-sized part of the market, with transaction sizes between USD 10 and 50 million. Our average transaction size historically has been between USD 10 and 20 million. Typically these transactions are not intermediated; therefore we see generally less competition and more directly negotiated transactions.

VC Magazin: What type of investor is under the biggest seller pressure?
Brody: It is very difficult to point to any one segment. In late 2007 and early 2008 I would have said financial institutions. This is no longer the case: The variety of potential sellers has become surprisingly well spread.

Substantial Increase in Distressed Deals as a Percentage of Overall Auda Deal Flow



Source: Venture Economics

VC Magazin: Secondary transactions include fund stakes in mature private equity funds, medium stage private equity funds, early funds as well as secondary direct transactions, preferred interests and GP spinouts. Which of these areas are most attractive in the current market environment?

Brody: All of these transactions are attractive right now. The one area we would view as relatively less attractive for us as a secondary buyer is the purchase of highly unfunded interests. We do think there are good opportunities in that segment, as sellers may be willing to accept highly discounted prices on the funded portion of the commitment in order to relieve themselves of the unfunded obligation. However, the high levels of blind pool capital and the resulting longer duration of the acquired portfolios do not really meet the fundamental criteria of a secondary fund. Luckily, Auda runs an integrated platform, meaning we have a well-established primary program as well as a dedicated co-investments effort. This puts us in a very good position to refer any highly unfunded portfolios we source to our primary team. The key question there is whether the primary team wants to increase its existing exposure to the managers in the portfolio being offered. As a firm we refer to these opportunities as aged primaries or primaries with a kicker.

VC Magazin: We are hearing more about private equity funds themselves issuing preferred interests. What reasons might drive a fund to offer such a preferred interest?
Brody: There are several different kinds of situations. Always, the transaction is driven by a need to support fund commitments of some kind. For example, it could be a fund-of-funds that pursued an over-commitment strategy and needs to raise fresh capital to meet its underlying obligations. Or it could be a buyout fund that is fully invested and needs more cash to support certain of its portfolio companies that are being squeezed by their banks due to the current crisis. A similar situation arose at the beginning of this decade. Many venture capital firms invested their capital very quickly as the Internet bubble expanded and weren't adequately reserved to support their existing portfolio companies when the bubble eventually burst. These situations were often solved with annex funds. However, annex funds may not be attractive to investors for several reasons, and raising them may be particularly difficult now when many limited partners are themselves capital constrained.

"Secondary funds will tend to mitigate the J-curve effect"

VC Magazin: Auda has backed HeidelbergCapital in their acquisition of a 3i venture portfolio in Germany in June 2008. Are you looking at similar deals in Germany right now?
Brody: We were very pleased to help finance the purchase of that portfolio and to partner with the new team at HeidelbergCapital. It is a high quality portfolio and a great team. We will continue to seek out similar opportunities in Germany or elsewhere.

VC Magazin: What is your outlook for the private equity market in the German speaking countries compared to the US?
Brody: Clearly, private equity as an asset class has suffered some setbacks lately. Those difficulties have been global in the same way that the economic downturn has been global. As a firm, we continue to believe very strongly that private equity as an asset class can add significant value to a well diversified portfolio. But there will be changes. For example, we expect that the number of active private equity firms will decrease significantly as raising subsequent funds becomes increasingly difficult. There is also going to be an increased – some would say a renewed – emphasis on investing with private equity fund managers who create value through operational changes as opposed to through financial leverage. We are pleased with this trend. In both Europe and the US, Auda has historically focused heavily on identifying and investing with middle market buyout managers who have the skills to add operational value and track records to prove it.

VC Magazin: Thank you for this interview! ■

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About Timothy Brody

Timothy Brody is a Managing Director at Auda Private Equity based in New York and heads the firm's global private equity secondary market activities. Brody has spent the last nine years focused exclusively on the private equity secondary market and has led or participated in 39 completed secondary transactions, representing over USD 1.3 billion in total deal volume. Auda was founded in 1989 by the Harald Quandt family.


Greenpark
Capital








Drawdowns
Distributions
Cash Flow to LPs



P+P

In Step with the Private Equity Zeitgeist

The Munich Venture Forum "Secondary Transactions"

March 20th 2009, Friday afternoon – time to join the EVCA ski networking event in Arosa. Yet more than 250 private equity professionals were drawn to a different venue: The Munich Venture Forum hosted by the law firm P+P Pöllath + Partners. It was the second of its kind, its ordinal number going nicely with the theme of the day: Secondary Transactions.

Waiting for the first move

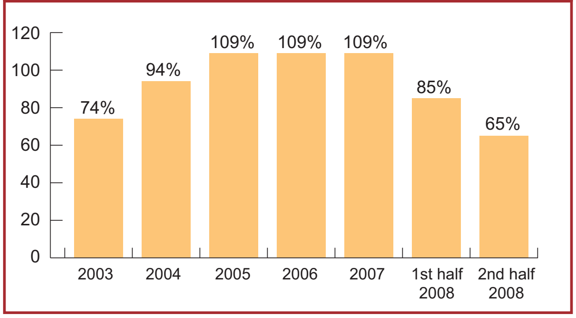
"On my way to this conference I spoke to a general partner. He told me that a company from his portfolio had gone into bankruptcy. Just eight weeks ago he told me that the same company was in a difficult position but could be saved. In the last eight weeks dramatic things happened at the company that none of us could have foreseen. In the GP report that the limited partner knows of, this company is still valued at 0.3 times the cost. If I had told him seven weeks ago that the valuation of this company should have been zero, he would have thought I was trying to get the better of him. The true value has to be reflected in the books of the limited partners before buyers' and sellers' expectations are going to meet." With this first-hand report, Stephan Illenberger of Axa Private Equity concluded his presentation at the Munich Venture Forum.

The large gap between bid and asking prices was one of the most frequently discussed subjects of the conference. Or, as Axel Hansing of Coller Capital put it: "There is a lot of talk and very little action." However, in a recent survey by his firm, 64% of 109 limited partners cite a requirement for increased liquidity as being a driver of the secondary market for the next two years. Considering this, and the enormous firepower of secondary funds-of-funds, the question is not *if* the secondary market is going to pick up pace, but *when*.

Big discount territory

Marleen Groen, founder of Greenpark Capital and one of the most influential women in European private equity, was barely able to hide her enthusiasm about the opportunities that are just around the corner: "This year is going to be the mother of all secondary years!" Although Groen is expecting net asset values in March and June to come down further, the former executive of Coller Capital expects prices for secondaries in absolute terms to be relatively stable. Groen's explanation: "We are already in big discount territory. A 40% discount on net asset values was common in the second half of 2008." This dramatic decline in prices was visualised by Stephan Illenberger in his presentation:

Secondary pricing of buyout funds as a percentage of net asset value



Soruce: Cogent Partners, Axa Private Equity Research

Conclusion:

The second edition of the Munich Venture Forum was a huge success. An impressive line-up of speakers provided the audience a thorough understanding of the variety and current state of the secondary market. The only missing view was that of a seller of LP stakes. It might well be that they are just too *dis*tressed to make a conference appearance. ■

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Speaker line-up

Werner Dreesbach, co-founder of Cipio Partners
Marleen Groen, founder of Greenpark Capital
Axel Hansing, partner of Coller Capital
Stephan Illenberger, member of the Executive Board of Axa Private Equity
Amos Veith, partner of P+P Pöllath + Partners
Gunter Waldner, principal at AlpInvest Partners

For extracts of the panel discussion at the Munich Venture Forum see pages 16-17

“The Seller is basically your bank”

Extracts of the panel discussion “Secondary Transactions – Opportunities and Challenges”

Different viewpoints were exchanged at the “Secondary Transactions – Opportunities and Challenges” panel discussion that took place at the Munich Venture Forum on March 20th. Timothy Brody of Auda, New York, contributed a US perspective, while Edmund Reed of the law firm Travers Smith, in London, introduced a UK angle; Dr Clemens Doppler of HeidelbergCapital presented the considerations of a secondary direct buyer, while Dr Ralf Schnell of Siemens Venture Capital presented those of a portfolio seller; Emmeram von Braun, from von Braun & Schreiber, supplemented the discussion with ideas from a fund-of-funds position and Dr Michael Inhester, partner of the hosting law firm P+P Pöllath + Partners, moderated the panel.

Timothy Brody, Dr Michael Inhester

Inhester: Edmund, what is your impression of the state of the secondary private equity market?
Reed: One aspect that will be quite interesting as pricing settles down, is what it tells you about the various private equity models and strategies that are out there at the moment. The direction in which the pricing of secondaries develops will tell us which of these models are likely to survive.

Inhester: How is the current situation for a fund-of-funds investor?
von Braun: One thing that has gone away is leverage. There used to be leverage in the secondary market just like you had in direct deals. Today, you need to negotiate with your counterpart in the transaction, which is the seller. He is basically your bank. So with him you can structure transactions with seller notes, certain cascades of liquidities, etc. This also took place in the past, but is more prevalent today. In that sense we are seeing a slightly different market today.

Dr Michael Inhester, Dr Clemens Doppler, Emmeram von Braun

Inhester: Highly detailed information is needed to assess the quality of an underlying portfolio. Sometimes intermediaries push the bidding process very hard and structure it like

Edmund Reed, Timothy Brody, Dr Michael Inhester, Dr Clemens Doppler, Emmeram von Braun

an M&A transaction, although it is very different due to the large number of companies involved. This makes it very difficult to submit an offer letter based on a meaningful valuation. How do you handle that challenge?
Doppler: We joined several bidding processes, but we always failed. And that is probably the answer to your question. You have to evaluate a dozen, or whatever number of, assets very quickly. You have to know the markets in which these companies operate and you have to have operational experience in your field of asset management. In the end, you do your valuation with some sort of a discount on the entire portfolio, because you are not able to assess every company in depth in two or three weeks.

Dr Ralf Schnell

Inhester: Ralf, is the process of evaluating the underlying assets of a corporate venture capital portfolio any different?
Schnell: Whether the seller is a corporation or not makes no difference for the buyer. Let me point out something else: It is not only difficult for the buyer to pitch properly, it can also be hard for the seller to select the right people to invite for the completion of the proper due diligence. When we sell a larger portfolio we go into a staged bidding process. That means that we invite 10+ people to give us a preliminary bid. What we get from this is a selection of offerings, including precise prices, lowball prices and people who give a range. At that point we have to decide which four or five people we provide with access to the data room and allow to carry out management interviews. To select the right people at that stage is not easy for us since, as a seller, I do not know how aggressively the buyer will negotiate once he has been in the data room.

Inhester: How do you choose which opportunities to look at more closely?
Brody: Given all the transactions that we see, the question for us is: Where can we identify those situations where we have some kind of competitive advantage? This is one of the few remaining businesses where excess returns can be achieved because of information asymmetries. Our objective as a secondary buyer is to add a lot of value after having acquired a portfolio.

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"Corporations and financial institutions are very good transaction partners"

Interview with Werner Dreesbach, Cipio Partners

"Compared to the universe of vintage year 2004 funds, we are probably the fund with the highest repayment rate in the entire secondary and technology field in Europe and the US," says Werner Dreesbach self-confidently. He admits that this cannot only be attributed to the outstanding performance of the team but also the special business model of Cipio Partners. Werner Dreesbach and his fifteen-member team specialise in secondary direct investments – the purchase of portfolios of company interests that corporations, financial institutions or private equity houses are no longer able or willing to hold. Cipio has initially funded such acquisitions on a case-to-case basis. This is supposed to change in 2009: the Cipio team is raising a discretionary fund with with a target size of 200 million Euros.

Werner Dreesbach

VC Magazin: In 2004 – the second year of your existence – you acquired portfolios from DaimlerChrysler, Deutsche Telekom and Infineon. In an interview with us in spring 2005 you said that you do not look at the number of deals but at their quality. Since then the rate of your acquisitions has fallen significantly. Does that mean that between 2006 and 2008, the quality of the deal opportunities in the secondary direct market was significantly worse than before?

Dreesbach: Except for two cases, we in fact carried out all of our investments in 2004 and 2005. However, the problem was not that the portfolios offered for sale generally had a lower quality, but that valuation levels had materially increased. We did not buy anything in 2006 since the prices were unreasonably high – out of eight or nine binding offers we submitted, none was accepted. Other parties offered up to 30% more than we did. But we decided to remain disciplined and did not allow our bids to be negotiated up. Our business is not to make deals but generate strong returns from each deal. It is only since late 2007 that we have seen prices falling again and the transactions are becoming attractive again measured against our risk-return expectations.

VC Magazin: How do you fund your deals?

Dreesbach: To date, we have financed our transactions on a deal-by-deal basis, that is we talked to institutional investors in parallel to each due diligence and price negotiation, asking them for their support for each transaction. We are now changing our funding model: we are currently raising a 200 million Euros discretionary fund out of which we will then buy portfolios. This has been our plan right from the beginning. In 2003, however, we would not have had any chance to successfully launch a discretionary fund as a new team with a completely novel business model for Europe.

VC Magazin: What does your investor structure look like?

Dreesbach: We are proud that we have been able to win quite a number of German limited partners for our new fund. These include German family offices, banks and

insurance companies. We have also received first commitments from outside Germany, though we did not start fundraising internationally before the middle of last year.

VC Magazin: Is there a sufficiently large number of portfolios available for acquisition in order to reasonably and promptly invest a larger fund?
Dreesbach: Yes, we review between 60 and 70 portfolios a year.

VC Magazin: That is more than I expected. Do they only come from the venture capital field?
Dreesbach: As we principally do not take technological risk, we prefer to call it growth capital. A company that we like to acquire a stake in typically generates sales in the lower two-digit million range, has a complete management team, is between six and eight years old, maintains a representation in Europe and the US and is cash flow break-even. The main reason for the acquisition of technology-oriented companies is the attractive prices in this segment. However, we can also imagine acquiring non-technology companies as long as the price is reasonable. This has not been the case during the past few years due to the buyout boom, but it appears to be changing now.

VC Magazin: What speaks in favour of this focus?
Dreesbach: There is a very relevant statistic by CEPRES on this topic. Over the course of 19 years, it recorded the likelihood of a complete write-off on a company funded by private equity funds. In the venture capital field, the figure amounts to some 40%. In the buyout segment, total write-offs were at a surprisingly high 10%. We have only lost some 5% of our companies during the five years of our existence. This is primarily due to the fact that we only buy following a very long holding period by the primary investor. Thus, we do not acquire those companies that did not manage to survive. It is quite unlikely that a company will fold after six or eight years of being in business.

VC Magazin: How likely is it that one discovers a company such as Google or Skype after six or eight years?
Dreesbach: It is fairly unlikely – however, these are not the type companies we target. You cannot have the profit potential of a Google without assuming high residual investment risk. Our concept is to make a reasonable multiple at manageable risk levels not only with each portfolio but with each individual company.

"Our business is not to make deals but to produce strong returns from each deal"

VC Magazin: Let's stay in the US: when I visited the venture capital investing conference in San Francisco in June 2008, I met only one other German: one of your colleagues from Cipio Partners. Why is the much talked-up US venture capital market an interesting field for you – few others here in Germany seem to go after it?
Dreesbach: In fact, I am not able to mention any German investor apart from TVM Capital spontaneously that operates a real branch office in the US – thus your question is absolutely justified. Though we have mainly made acquisitions in Germany, 50-60% of our companies are based in the US. We manage these from our office on the West coast. The latest portfolio, which we acquired from Siemens, is comprised of 14 American companies and two interests from Israel. We always consider portfolios if the companies offered for sale are based in Europe, the US or Israel.

VC Magazin: Cipio Partners is certainly the most experienced secondary direct investor in Germany. What have you learned from your previous transactions?
Dreesbach: If you want to be successful in this business, you will have to ensure short holding periods and create a highly diversified portfolio. This is one of the reasons why we are now launching a 200m euro fund. In the past, we saw portfolios which consisted of only four or five companies from a single industry segment such as semiconductor equipment, located in a single geography. Such portfolios present a very high cluster risk, if consummated on a deal-by-deal financing basis. However, if these companies can be integrated into a larger, diversified fund with many other interests, we expect to be able to achieve the full return potential of such a small portfolio acquisition while being able to reduce the material risk for the investors at the same time.

VC Magazin: What is your preferred transaction size?
Dreesbach: We like to acquire portfolios in the 10 million to 20 million Euros range. We can also handle larger secondary deals of up to 100 million Euros, but the larger a transaction is, the more competitive the sales process typically is. Smaller portfolios, however, are often intended to be silently and quickly transferred to an investor with a good reputation – while the price is often only of secondary importance for the seller. Among the

"We want to achieve an IRR that significantly exceeds that of primary funds in the venture capital or buyout field"

transactions completed by us, there was only one with which we finally made the highest bid – and only by a small margin.

VC Magazin: Does that mean that you prefer to buy from corporates?

Dreesbach: Corporates and financial institutions are very good transaction partners for us. This is also due to another reason, however: you typically deal with only one selling entity which owns 100% of the portfolio for sale. Negotiations with private equity funds are more difficult since they are in most cases funded by several limited partners, who often want to take part in the discussions at least through the advisory board.

VC Magazin: Do you nevertheless consider such transactions?

Dreesbach: We are not at all afraid of such circumstances. For example, we have acquired a portfolio from a private equity fund in Belgium and are regularly reviewing such deals. In view of the challenging circumstances in this environment in particular, the opportunities in private equities have increased significantly.

VC Magazin: At this year's SuperReturn conference in Berlin, Henry Kravis said that most of the time will now have to be devoted to the maintenance of the existing portfolios. What are you dealing with in the current market environment?

Dreesbach: We think the market for secondary direct transactions will be very attractive in 2009 and 2010. Though there is currently a lot of movement particularly in the LP stake segment, only very few transactions are being completed right now. There are plenty of LP stakes for sale in large buyout funds. However, the discrepancy between the price expectations of the sellers, who are still looking at their latest reporting, and the prices the buyers, who are anticipating significant depreciations on the net asset value of large buyout funds, are willing to pay is still too high at the moment. In the secondary direct business, by contrast, the net asset value plays a significantly smaller role, which means very attractive transactions can now be made. We certainly are very busy at the moment.

VC Magazin: But how do you valuate portfolios?

Dreesbach: We analyse the exit potential for each company included in a portfolio under a minimum of three different scenarios. Taking these as a basis, we then carry out a Monte Carlo analysis in order to understand the general risk-return profile of the transaction and the probability distribution of the sales proceeds. On that basis, we ultimately get to our purchase price.

VC Magazin: How much is your purchase price offer below the sales proceeds that you expect?

Dreesbach: We want to achieve an IRR that significantly exceeds that of primary funds in the venture capital or buyout field. It is possible to consistently achieve this in the secondary direct business due to the short holding periods.

VC Magazin: Thank you for the interview! ■

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About Werner Dreesbach

Werner Dreesbach is the co-founder and Managing Director of Cipio Partners. Since its foundation in 2003, the Munich and San Jose-based specialist in 100% equity funded secondary direct investments has acquired interests in some 75 companies, of which it has so far realised about 35. The largest portfolio acquisitions carried out by Cipio Partners include transactions with Deutsche Telekom, DaimlerChrysler, Infineon and Siemens.

Be Prepared for Challenges and Opportunities!

Legal Aspects of Secondary Transactions

Secondary transactions have become an integral part of the market activities in Germany in past years. Over the last several months, due to the financial crisis, the secondary market has been the subject of even more attention. Investors are increasingly expected to seek the liquidation interests in private equity funds in an effort to clean their balance sheet, reallocate their assets and reduce their unfunded liabilities. From the perspective of both the seller and the buyer, secondary transactions have specific impacts which distinguish them from "traditional" exit channels.

Sellers' and Buyers' Motivations

Under the current market circumstances, the sale of private equity portfolios will – from a seller's perspective in particular – be motivated by the need for liquidity, the unsatisfactory performance of several funds or, with respect to corporate sellers, by the concentration on their core business activities. From a buyer's perspective, the motivation for participating in the secondary market will be driven by the specific sale situation in order to realize reasonable pricing; secondary market positions may usually be purchased at a certain discount. Furthermore, investments in secondary transactions are more mature than in primary transactions since secondary acquisitions invest in portfolio companies in which significant amounts have already been invested. This imminently reduces the risk of "blind" investments and creates more sustainability for the buyer. Finally, a secondary transaction offers a certain acceleration of financial returns, which gives more security to the purchaser.

Structural Challenges

There is neither an organized nor a formalized market for companies financed by private equity. Unlike a strategic investor, an institutional investor does not normally intend to use strategic synergy potential and will consequently not include such effects in the determination of its purchase price. A strategic investor, however, may use strategic synergies as well as market and value-enhancement potential and, as a result, such effects will be (positively) reflected in the valuation of the target company and the purchase price accordingly. Therefore, secondary transactions rarely represent successful exits in IRR or multiple terms. Consequently, they are conducted with a greater level of secrecy than deals in other areas of the market. On the other hand, secondary investors may expect attractive investment opportunities, particularly in periods of market consolidation, reorganization or strategic reorientation. Specifically, financial institutions, pension funds and others affected by the current financial crisis might look to sell private equity interests or portfolios to a growing set of dedicated buyers, even below market value.

Legal Challenges

At first glance the acquisition of a company or a portfolio of companies by way of a secondary transaction seems to be similar to a primary transaction. Particularly from a legal point of view, it does not make any difference whether a shareholding is transferred by a strategic buyer or an institutional investor. However, compared to "ordinary" transactions, the auction process is of vital importance in secondary transactions. Because of the lack of a "real" market valuation indicated by a strategic buyer, the valuation of the interest or portfolio underlying the purchase price needs to be determined in the auction process. Considering this general framework, many advisors are prepared to conduct a vendor due diligence in order to standardize such process and to create a competitive environment between the bidding investors. If, for example, the pool of buyers is small and the seller is under pressure to dispose of its commitments, negotiations and due diligence will need to take place quickly. The time frame for the consummation of a secondary transaction is therefore normally very tight, which leads to a dynamic transaction process. Therefore, the detection of interesting, risk-adjusted and profitable investment opportunities requires purchasers who are detail-oriented. Competitive secondary managers and their advisors need fundamental experience in fund investments, as well as in private equity investments, in order to ensure successful secondary transactions.

There will, in particular, be little time for extensive due diligence related to the target portfolio. On the basis of such framework conditions, the specific determination of opportunities and risks related to the transaction may only succeed if a structurally coordinated team, which has the appropriate knowledge and resources to undertake such due diligence, is able to distil from the plurality of documentation such information which shall sufficiently and adequately serve to analyze the risks. It is often not enough to rely solely on the seller's valuation of an asset portfolio to price a secondary interest; their estimates can be biased, inaccurate or outdated. In particular, venture capital investments may be too immature to value and distressed assets may not have fully turned around yet. Therefore, due diligence needs to be focused on the essential transaction structure and facts related to purchase price. From a lawyer's perspective, particular emphasis should be placed on the existence of subsequent payments commitments, on the transferability of investors' privileges and the observation of pre-emptive and tag-along rights in the cases where a portfolio of companies is to be sold within a secondary transaction. As a result, the acquisition of a company portfolio is often connected with (partially significant) purchase price deductions as compared to regular trade sale transactions.

Particulars of a Sale of a Company Portfolio

In addition to the limited due diligence, the transaction structure for the purchase of an existing portfolio of companies is often a particular challenge for the parties involved. Ideally, the purchaser acquires a holding company in which the portfolio companies are concentrated in order to exclude the application of direct change-of-control clauses. If such concentration is, for example, not possible because the portfolio may not be transferred in due time into a special purpose vehicle, each single company participation has to be sold and transferred separately. Thus, the involved parties face a plurality of single transactions within "one" secondary transaction. As a result, for each single transaction the advisors have to observe merger control mechanisms and potentially different jurisdictions. The same applies to pre-emptive and tag-along rights, as well as to gaining the required consent of third parties. The process of obtaining such consent from co-investors or minority shareholders may substantially slow down the closing process. To head off such problems and delays in advance, the closing procedure for each single transaction may be agreed upon in detail within a framework agreement. In such a framework agreement, mechanisms for the payment or adjustment of the purchase price, the allocation of dividend claims, transfer restrictions, rescission and information rights for the time between signing and closing, which will then be applicable to all subsequent single transactions, may be determined.

Conclusion

The credit crunch and lower performance of certain private equity funds may lead to an increase in secondary transactions in the next several months, given that the impact of the credit crunch could get even worse or because investors can no longer comply with their contractual fund commitments. As the secondary environment grows, it will also become more competitive. Therefore, the legal and business landscape is also likely to change. It is important for buyers, sellers and their advisors to be prepared for the challenges and opportunities that are likely to arise in the secondary market. ■

About the Author

Dr Michael Inhester is an attorney-at-law and partner at P+P Pöllath + Partners, Munich. He specialises in providing legal advice to investors, sellers and management teams in buy-out as well as venture capital investments.

Case Study

Getting Involved

After Buying a Venture Portfolio from 3i in 2007 and 2008, HeidelbergCapital Is looking for New Investment Opportunities

When the London based private equity firm 3i decided to sell a portfolio of shareholdings in various corporations early in 2007, almost every established secondary direct investor took a closer look. Just a few months later many of them were taken by surprise when newly formed HeidelbergCapital snatched the deal. The winning strategy: While other bidders tried cherry-picking, HeidelbergCapital offered to buy the whole portfolio.

Sourcing the deal

Before founding HeidelbergCapital, Prof Dr Martin Weiblen was a Managing Director of a large family office in London. Shortly after leaving this position he got wind of the fact that 3i was looking for a buyer for a slice of its German portfolio. Dr Clemens Doppler's role as a 3i partner in Stuttgart, at that time, was to find a buyer. So Weiblen and Doppler were sitting on the two sides of the negotiation table. From his network Weiblen had managed to convince the multi billion dollar alternative asset manager Auda to back a tender. Although HeidelbergCapital was a newly formed entity, its bid to buy all of the 26 offered companies combined with the strong reputation of Auda convinced 3i to go for the newcomer.

Building a new investment manager

At that point the real effort was only just beginning. Weiblen remembers: "One of the biggest challenges in this deal was closing the transaction. Since the portfolio that was for sale did not belong to a discrete fund but to several separate entities, 26 individual, notarised contracts had to be completed." Supported by their legal advisers, pre-emption rights were clarified, antitrust hurdles resolved and 23 sales and purchase agreements eventually signed. Finally, with the pitfalls overcome, one of the largest private equity secondary direct transactions in Germany was closed.

"One of the biggest challenges in this deal was closing the transaction."

Parallel to these efforts Weiblen built up his operations: "Since 3i wanted to reduce its workforce, we had the opportunity to recruit personnel from them", says Weiblen. Doppler changed sides and became Managing Partner of HeidelbergCapital. In January 2008 the new firm moved into an office in the city centre of Heidelberg. Doppler reveals: "Both Martin Weiblen and I live in Heidelberg. Given the very comprehensive business landscape that the *Metropolregion Rhein-Neckar* offers, this was a clear choice though. Besides, our American investors love the city and the castle."

Supporting the portfolio

When Weiblen and Doppler moved into their new office only a few companies had already legally changed ownership. The difficult asset transfer took until the fourth quarter of 2008. That was when the last transaction was finally completed. Today, the substantial amount of legal documents fills roughly half of one of the two conference rooms of HeidelbergCapital. "If that space is needed for growth we can move our archive into the cellar", explains Doppler and points at the vast amount of attractive investment opportunities on the horizon. For the time being the investment professionals are focusing their efforts on the existing portfolio. "We started by taking on supervisory board responsibilities, establishing business reporting and talking strategies and policies. However, given the present general market environment, we now have to focus pretty much on operational and tactical issues", summarises Doppler and adds: "We notice now that many portfolio companies not only inform us of their development. They look at us as a partner that is involved and give us helpful advice." ■

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Dr Clemens Doppler, Prof Dr Martin Weiblen, HeidelbergCapital

Follow-up interview with Prof Dr Martin Weiblen and Dr Clemens Doppler, Managing Directors of HeidelbergCapital Asset Management GmbH

VC Magazin: Are you still happy with the acquisition of the 3i portfolio or would you do things differently from today's viewpoint?

Weiblen: We are still convinced that this deal was beneficial to everyone involved. It was a new experience since such a complex transaction had never been done in Germany before. Having said that, there is no doubt that the current developments in the market hit us twice: On one hand as a member of the financial sector, suffering from its crisis and its new reputation, and on the other hand as a stakeholder in real companies that suffer from the economic downturn. Nevertheless, we are different and therefore still see our business model intact: On the financing side we have not used any leverage, which is a big advantage today, and on the business side the fundamentals of our companies are still widely unhurt. Although the negative facts of the crisis are naturally not increasing the value of our portfolio, we are still confident that our portfolio with its wide range of industries and development stages will eventually balance out and that we can fulfil the promises we have made to our investors.

VC Magazin: How has the financial crisis affected your exit strategy?

Doppler: The automotive sector and some parts of the IT industry are having a very difficult time. On the other hand, high technology players are still showing a lot of interest in our portfolio companies. Our timeline will be affected, but we do not see this as life-threatening. Presently, the highest priority for all our portfolio companies is short-term liquidity management. If this is secured, we will focus on positioning the companies in a way that they are poised for an upswing – whenever that will be.

VC Magazin: What holding period would you predict on average?

Weiblen: Presently some four to five years maximum, although this is hard to say in the current market environment. If the crisis lasts very long it will naturally cause further delays in our exit plans.

VC Magazin: What are you planning for the investment side in the coming months?

Doppler: We want to buy further portfolios, as our whole structure is designed to do so. We are looking at venture capital and growth capital direct transactions, but we would not consider highly leveraged buyout portfolios or fund stakes. We are also looking for strategic single acquisitions in order to strengthen the competitive advantages of certain of our portfolio companies.

Weiblen: With our network of partners we can complete smaller acquisitions and handle larger transactions. We shall also consider raising a new fund, for which we have the structures already in place. We view the foreseeable future has being a time to buy and not necessarily a time to sell; to leave attractive sales from our portfolio to strategic value investors with the same view. ■

Global Investments, The European Way

Axa Private Equity

Axa Private Equity is a heavyweight in the global Private Equity industry: In less than 13 years the investment management company has growen the assets under management to more than USD 25 billion. The firm operates eight offices on three continents and participates in every major segment of the private equity market. With firepower of several billion dollars in its secondary funds-of-funds alone, Axa Private Equity is well positioned to offer a solution to sellers of private equity fund stakes that are in need of liquidity. However, having all bargaining power on its side, Axa Private Equity can afford to wait.

Characteristics of Axa Private Equity

- **Offices:** Paris, Frankfurt, London, Milan, New York, Singapore, Vienna, Zurich
- **Founded:** 1996
- **German subsidiary:** "Axa Private Equity Germany GmbH" established 2001
- **Holder:** Axa Group (100%)
- **Regional focus:** Europe, North America, Asia
- **Funds-of-funds:** primary, early secondary, secondary
- **Direct funds:** infrastructure, LBO mid cap and small cap, venture capital, co-investment and mezzanine
- **Philosophy:** sustainable growth and innovation for portfolio companies

100% Axa, 70% third party commitments

As the name suggests, Axa Private Equity is part of the Axa Group, one of the largest insurance conglomerates in the world. As a dedicated believer in private equity, Axa Group decided to establish a private equity manager in 1996. Since then the alternative asset specialist has grown to more than 100 investment professionals that handle more than just group money: About 70% of the capital managed by Axa Private Equity today has been committed from third party investors. On average the firm invests more than USD 2.2 billion per year, has around 100 direct holdings and a portfolio totalling 500 funds. With its numerous investment vehicles, Axa Private Equity participates in a broad range of companies and situations. Areas that are excluded are mainly those that have the potential to contradict the insurance group's stated goal of showing solidarity and support for their client base. Examples would be turnaround situations or sensitive industries such as weapons, alcohol and tobacco.

Axa Private Equity activities

Axa Secondary Funds USD 4.1bn	Axa Early Secondary Funds USD 1.7bn	Axa Capital Europe Funds* USD 1.2bn	Axa Capital America Funds* USD 800m	Axa Capital Asia Funds USD 1.1bn
Axa LBO Funds USD 2.9bn	Axa Expansion Funds USD 670m	Axa Co-Investment Funds USD 2.2bn	Axa Capital Funds* USD 460m	Axa CEE Funds USD 240m
Axa Mezzanine Funds USD 3.1bn	Axa Infrastructure Europe USD 1.8bn	Axa Infrastructure Emerging* USD 300m	Mandates and others USD 6.5bn	Axa Venture Funds USD 250m

* Commitment as of December 31st,2008
Source: Axa Private Equity; exchange rate EUR 1 = USD 1.3917

Ready to exploit

Stephan Illenberger, member of the Executive Board of Axa Private Equity, is convinced that the firm is well prepared for the challenges ahead: "Our portfolio firms prove that private equity is enabling growth." One of the segments in which Axa Private Equity is a global leader is secondary funds-of-funds. As more and more institutional and high net worth investors looked for ways to gene-

"The private equity industry is about to change: On the one hand we will see some very large players, while on the other hand there will be small, highly specialised niche investors. For sure some – even bigger – names will disappear."

Stephan Illenberger, Axa Private Equity

Stephan Illenberger spoke about the pricing of secondary transactions in the current environment at the Munich Venture Forum

rate liquidity, this part of the private equity market became highly attractive. However, in spite of a massive increase in deal flows, larger transactions are rarely happening. The reason: Buyers are offering to buy at sizeable discounts that sellers are not yet ready to accept. "Once net asset values have been written down, sellers expectations will adjust", says Stephan Illenberger. He is convinced that "staring in mid 2009 new transactions for our secondary funds-of-funds will be signed". Once the Gordian knot gets cut, the secondary market might explode. Globally, the firepower of all secondary funds-of-funds is estimated to reach almost USD 20 billion. Fund stakes that are labelled "for sale" already exceed USD 50 billion. Secondary investments are therefore a prime example of a buyers' market that Axa Private Equity is ready to exploit.

Developing long-term strategies

In June 2008 Axa Private Equity completed the fundraising for its latest fund: a 1.6 billion Euros mid-cap leveraged buyout fund that focuses on investing in companies with an enterprise value of 100 million to 2 billion Euros. The money will be predominantly invested in France, Germany and Italy. First transactions include the buyouts of Diana Ingredients S.A., Unipex S.A. and Löwen Play GmbH. Illenberger comments on the investment strategy: "We select our investments by their potential to advance. This includes developing new markets or merging with a competitor." The fine chemistry company CABB, which is headquartered near Frankfurt and was acquired by Axa Private Equity in January 2007, is a prime example of the buy-and-build strategy of its majority owner: In July 2007 Axa Private Equity helped CABB to purchase SF-Chem, a Swiss producer of intermediates for the pharmaceutical, agrochemical and specialty chemicals industry. With an annual turnover of 110 million Euros, SF-Chem was only slightly smaller than CABB. Less than a year later, CABB took a majority stake in a company in India to better access the Asian market. In general, Axa Private Equity aims at developing long-term growth strategies for portfolio companies and also offers the provision of access to its global network.

Outlook

In the long run, Illenberger expects the significance of private equity to grow: "Bank financings will become increasingly difficult to obtain and accessing the capital markets will be considerably more difficult in the future." With a broad toolkit of private equity strategies at hand, Axa Private Equity is under less pressure to pursue risky manoeuvres than private equity firms that concentrate on a specific market segment. Axa Private Equity should be able to adapt to the current environment by focusing more strongly on investment opportunities in attractive markets like secondaries, mezzanine or infrastructure, while helping its leveraged buyout portfolio ride out the crisis. ■

Selected portfolio companies:

Name	Industry	Country
CABB GmbH	Fine chemistry	Germany, Switzerland, India
Rail.One GmbH	Concrete sleepers/transport	Germany
Löwen Play GmbH	Entertainment	Germany
Spotless Group SAS	Home care products	France, Italy, UK

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LP Secondary

Substantial Opportunities in 2009

Secondary Private Equity – A Mainstream Move

The growth of secondary transaction volume over the past decade has increased dramatically, more than matching the rise in primary commitments to private equity. What started out as a niche market has grown into its own substantial asset class. So, what happens when investors in illiquid private equity funds want to sell? This is a question that is being asked with increasing frequency.

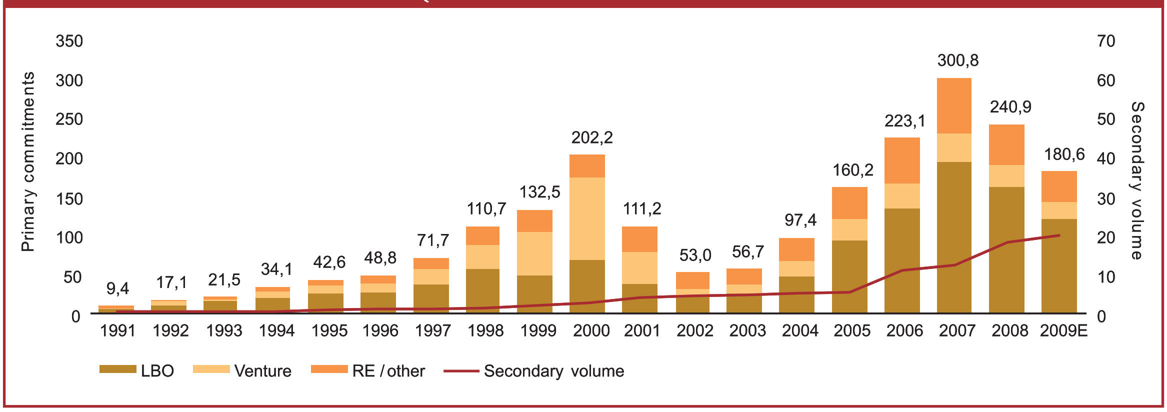
Institutionalization of the secondary market

Since the first secondary private equity transactions in the mid-1980s, when investors looked to liquidate their interests in a private equity partnership prior to maturity, commitments to the primary private equity market have grown by an incredible amount, providing the opportunity for secondary transactions to become more frequent. Secondary funds have since developed a distinct advantage over sellers as the supply-demand imbalance continues to favour purchasers, especially in this current market environment. However, since the first "one-off" deals, the characteristics of the secondary market have substantially changed. The market has become more institutionalised, so that large institutional investors such as pension funds and endowments and foundations have themselves become direct buyers of selected secondary opportunities. The profile of those selling private equity interests has also evolved, from distressed liquidators to proactive managers of private equity portfolios, although in the past 12 months the need for liquidity has been the driving force in the market.

An attractive asset class for qualified investors

The dramatic growth in private equity capital raised over the last 12 years (at an annual growth rate of 14.2%), combined with recent market turmoil and a focus on active portfolio management, has created a significant supply of secondary limited partnership interests for investors, bringing secondary deal volume to over $20 billion in 2008, according to the Dow Jones. This fundamental change has been made possible largely by sharp investors who see a chance to generate superior returns through three key advantages. Firstly, secondary investments can exhibit a mitigated "J-Curve" due to the early return of capital as investors are buying into a fund later in the investment cycle (typically secondary purchases are defined as 50-70% funded and 50-30% unfunded commitments). Investors can also make their own assessment of the existing assets and can therefore avoid some of the "blind pool" investment risk associated with traditional private eq-

CAPITAL COMMITMENTS TO U.S. PRIVATE EQUITY PARTNERSHIPS



USD in billions
Source: Credit Suisse

uity fund commitments. Finally, a secondary fund can provide enhanced diversification compared to primary funds, with investments across diverse underlying fund vintage years, fund sponsors, investment strategies, economic cycles, industries, and geographic foci.

Current market environment provides opportunity

From 1996 through to 2008, commitments to private equity funds have increased significantly, with over $2 trillion of capital committed to new “primary” funds. At the same time, the recent public market turmoil combined with increasingly proactive private equity portfolio management has created a growing need for liquidity, which has not been matched by the growth in secondary buyers (funds or institutional investors). From 1996 to 2008, approximately $65.8 billion of new capital was raised for secondary funds, or approximately 3.3% of total new primary private equity capital.

The increased need for liquidity and a desire to decrease unfunded liabilities on balance sheets, as well as active portfolio management, has driven this distressed environment. In addition, the promulgation of FASB 157, an accounting standard requiring illiquid assets to be marked to market, is expected to weigh heavily on the portfolios of all private equity funds. Valuations should potentially become more transparent, yet subject to fluctuations quarter-to-quarter, and, given the credit crisis and current public market declines, the traditional public market comparables used as benchmarks for valuations are likely to be significantly lower over the next several quarters. December 2008 valuations are now beginning to be distributed to limited partners, and the collective view is that many funds will have written down their portfolio by an average of 15-20% compared to third quarter 2008 valuations.

Secondary pricing environment

As a result of the global market turmoil, the dramatic increase in secondary transaction volume has caused the secondary pricing environment to shift significantly during the second half of 2008 and into 2009. When the equity markets collapsed in late 2008, sellers began to accept major discounts to their current valuations (typically in reference to the previous quarterly-reported value from the general partner), as they faced the prospect of being over-allocated to private equity or because they wanted to achieve liquidity in a limited amount of time. According to a survey by Cogent Partners, the average high bid for funds fell from 84.7% of NAV in the first half of 2008 to 61% of NAV through December 2008. This has affected all sectors of the primary and secondary private equity market as buyout, real estate, venture capital and other private equity managers face unrealised write-downs. However, as secondary investing enters the mainstream, secondary strategy continues to develop. Whereas the transactions in the early secondary market focused on providing “one-off” liquidity solutions, secondary managers are now focusing on diversifying fund portfolios to include funds specializing in real estate, venture capital and other “non-traditional” private equity sector strategies, enabling them to capitalise on the growing market for alternative strategies.

Positive outlook for the asset class

The expansion of secondary private equity activity looks to continue its strong pace as the current reverberations throughout the global economy cause all investors to re-evaluate their liquidity concerns. Since 2007, secondary funds have raised an aggregate $19.4 billion, with managers currently seeking an additional $28.3 billion in commitments – more than double the amount raised from 2005 to 2006. As the dust settles from the recent credit market collapse, 2009 should offer substantial opportunities for secondary funds as they provide investors with the opportunity to use the secondary market to recycle their allocations. The secondary market is expected to continue developing from a niche provider of liquidity into a fundamental component of the private equity industry, as investors use the secondary market as an active management tool to seek liquidity, rebalance their private equity portfolios and manage key general partner relationships. ■

About the Author

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"Nobody is moving"

Interview with Amos Veith, P+P Pöllath + Partners

Amos Veith advises clients on private equity fund stake transactions in the secondary market. He comments on the current lack of activity in the market and explains the potential legal pitfalls of which sellers and buyers need to be aware.

VC Magazin: Experts estimate that private equity fund stakes with a value of roughly USD 50 billion are for sale globally. Not so many transactions have been closed in the last months though. What needs to happen in order to stir up the market?
Veith: The most important thing that needs to happen is an adjustment of the pricing. There is still a huge gap between the expectations of buyers and sellers. Buyers are waiting for year end 2008 net asset values to come out to see how large the write-downs are. At the same time there is still a lack of confidence. Nobody is moving at the moment.

VC Magazin: When do you expect this to change?
Veith: My personal expectation would be that we may well see more deals in the third quarter of this year, or maybe even in the second quarter.

VC Magazin: Who are the sellers and buyers in the current market environment?
Veith: There are some banks and insurance companies on the sales side, but maybe not as many as you would expect. Rather we observe that they are not acting at all. On the buying side, professional secondary players and a limited number of professional institutions are the most important market participants.

VC Magazin: What are the essential legal aspects in a secondary LP stake transaction of which buyers and sellers need to be aware?
Veith: A clear cut in terms of the cash flows of a private equity fund stake that is to be sold is very important. This is usually a set date on which the buyer assumes economic ownership of the fund stake. Any contributions made by the seller after that date increase the purchase price, and any distributions made by the fund after that date reduce the purchase price. Secondly, representations and warranties need to be negotiated. Another question that is often highly disputed is the extent to which the buyer assumes the liabilities of the seller. A buyer does not want to be held liable for any breach of representation made by the seller or for any failure of the seller to comply with obligations under the partnership agreement. Finally, the risk of an LP clawback needs to be covered. This means that a limited partner is required to return the distributions received from a private equity fund.

Amos Veith

VC Magazin: Which clauses might become a proverbial powder keg in such a transaction?
Veith: We are currently seeing many buyers attempting to include a so-called "material adverse change" clause. Such a clause gives them the right to opt out of their obligation to acquire the interests if there is a material adverse change – whatever that means. Every buyer naturally tries to find a very open definition of this. In my view, such clauses are not generally justified.

VC Magazin: Have you seen secondary transactions that have failed to close because of this material adverse change clause?
Veith: No. I have seen two or three cases in which the buyer tried to negotiate such a clause but it was not accepted by the seller.

VC Magazin: What is the typical timeframe in which a secondary LP stake transaction takes to close?
Veith: Negotiating the purchase and sale agreement usually takes between three to four weeks. When under pressure, we have done it in as little as one week, however. The closing of such a deal generally takes between one to five months, depending on the number of funds in the portfolio.

VC Magazin: Thank you for this interview! ■

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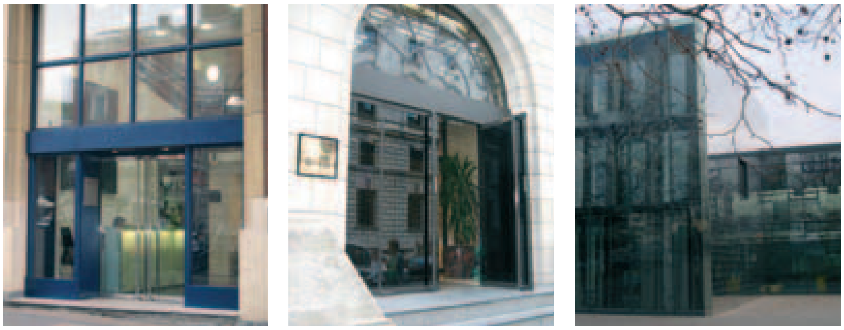
About Amos Veith

Amos Veith, LL.M. is an attorney-at-law and partner at P+P Pöllath + Partners, Berlin. He specialises in fiscal and legal advice for domestic and foreign institutional and private investors and initiators in the field of private equity funds, as well as in the field of fund-of-funds in the private equity, mezzanine and secondary sectors.



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