

Preqin Research Report
The Private Equity Secondaries Boom –
When will it occur?
Secondaries Pricing Analysis

December 2009



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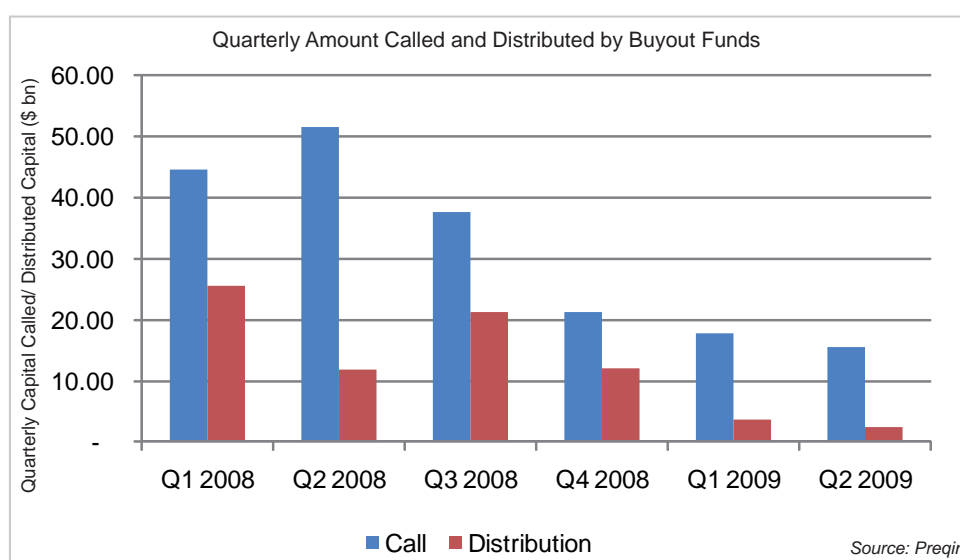
Introduction

The secondary market has grown significantly in recent years, with transaction volume reaching a record-high \$20bn in 2008. However, this figure can still be considered relatively low, given that it represented less than 1% of the size of the entire private equity industry. Towards late 2008, many private equity professionals expected that 2009 would become a big year for the private equity secondary market based primarily on two factors. Firstly, the global economic crisis was expected to encourage a number of distressed sales of private equity assets and secondly, investors were wising up to the benefits of the secondary market as a useful portfolio management tool.

Despite a great deal of interest and a large number of investors looking at the possibility of selling private equity portfolios, transaction volume has remained relatively low throughout 2009, with total secondary sales rumoured to have registered just \$6bn year-to-date as of November 2009. Despite the fact Q4 is often a big quarter in the private equity industry, we could expect total transaction volume for 2009 to reach a figure no greater than \$8-10bn.

The obvious question is why secondary deal flow has not reached the heights that were predicted during 2009, and the most likely answers point to the decline of the global economy and the introduction of FASB 157 reporting regulations. Both factors have made it more difficult for buyers to accurately assess the value of underlying assets within a private equity portfolio. Consequently, the relatively low volume of deals that have been completed have often involved distressed sellers and substantial discounts to net asset value (NAV). It is now thought that conditions are ripe for an improvement in secondary market pricing to catalyse the anticipated boom in secondary market deal flow.

Fig. 1:



Furthermore, while the volume of quarterly buyout capital calls declined from \$51.5bn to \$15.4bn in the period from Q2 2008 until Q2 2009, call ups have continued to exceed distributions, exerting pressure on investors to maintain the funding of their private equity portfolios (Fig. 1). It is also likely that private equity deal level will increase in the near future, following a recent spate of buyouts including the purchase of IMS Health Inc by TPG and Canada Pension Plan, which became the largest leveraged deal of the year. An improvement in secondary market pricing could encourage investors to the secondary market in order to relieve impending cash obligations.

Listed Private Equity as a Proxy for Secondary Market Pricing

Preqin has been closely monitoring the secondary market as it provides an area of interest to its own LP and GP customers. Part of our recent research has included a comparison between the trading discounts and premia of listed private equity and secondary market offerings. Fig. 2 shows how listed fund

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Fig. 2:

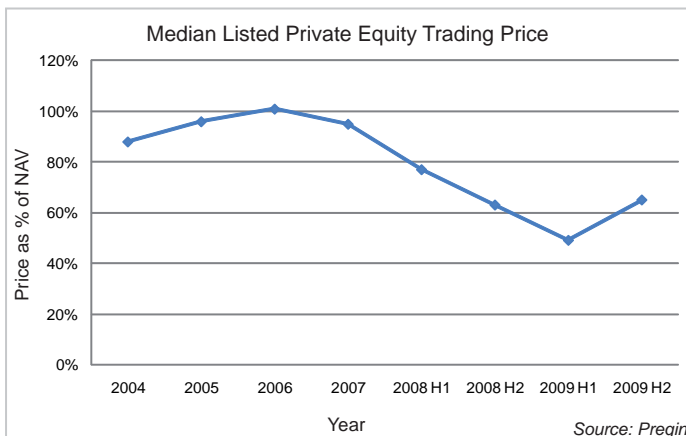
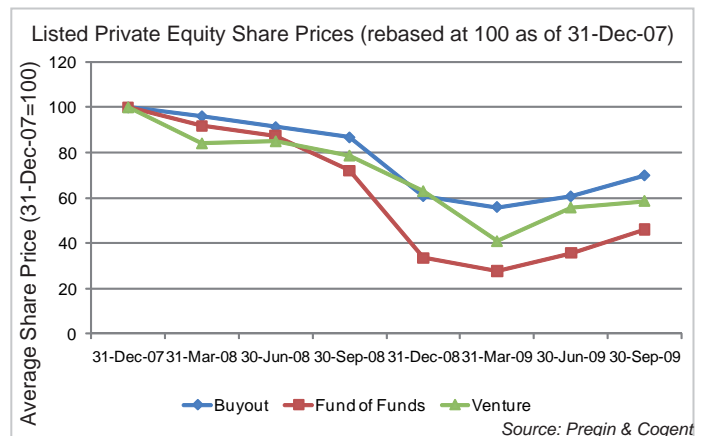


Fig. 3:



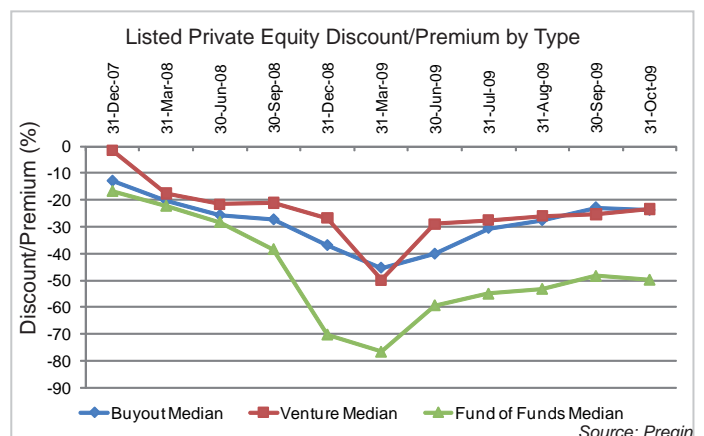
premiums and discounts have evolved over the past few years, going from par or modest premiums in 2004 - 2006 to very large discounts in 2008 and 2009. Readers who are familiar with the secondary market will recognise that this closely mirrors the evolution of secondary market prices (as tracked by analysts from various firms such as Cogent and Capstone.) In fact, these listed fund discounts provide a very accurate proxy for secondary prices, with the difference in pricing not exceeding 10% in any year.

Given these findings, Preqin has created an algorithmic model which provides indicative secondary market pricing for private equity fund interests. The model uses listed private equity as a proxy and calls on other factors such as vintage year of the fund, fund performance and fund manager track record in order to generate an indicative valuation. It also uses data from Preqin's Performance Analyst database, with net-to-LP returns for almost 5,000 private equity funds worldwide. The valuation can be taken by the user as a first assessment of the fund interest's approximate worth on the secondary market, but by no means provides a substitute for a thorough due diligence of the fund's underlying assets.

Where are Secondary Market Prices Headed?

Given the recent recovery in the global economy, listed private equity share prices have demonstrated a marked improvement since Q1 2009. When rebased at 100 as of year-end 2007, listed venture and buyout fund share prices increased by 44% and 25% respectively from March 2009 to September 2009 (Fig. 3) and seem to be approaching pre-crisis levels, having

Fig. 4:



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appeared to have reached a floor in March 2009. Furthermore, the subsequent increase in demand for listed private equity has seen the discounts at which it is traded, narrow. Fig. 4 shows that listed buyout funds, on average, were trading at discounts of 23.9% (76.1% of NAV) in October 2009, compared with 45.4% (54.6% of NAV) in March 2009. A similar improvement can be observed with listed venture funds, which were trading at discounts of 23.4% (76.6% of NAV) in October 2009, compared with 49.9% (50.1% of NAV) in March 2009. Listed funds of funds are still trading at much larger discounts, possibly indicating the value in this market segment.

Given the close relationship demonstrated between listed private equity and secondary market pricing, it could be expected that the recent marked improvement in listed private equity trading would have been reflected in secondary market pricing. Using Preqin's algorithmic model, we can observe the changes in indicative pricing against the most recently provided NAV at any period in recent history. It appears from Fig. 5 that secondary market discounts widened from March 2007, when we would have expected buyout fund interests to have traded at a small premium to NAV, until March 2009. Preqin's current pricing for buyout and venture fund interests (66.8% and 73.7% of NAV) is greater than the corresponding values at year end 2008 (58.8% and 66.3% of NAV) and may suggest secondary

pricing reached a floor in March 2009 on 50.7% and 53.0% of NAV respectively.

We could conclude from the graph, therefore, that since March 2009, pricing appears to be improving with time. With good reason, the secondary market didn't take off as expected in 2009, as sellers and buyers could not meet over price, but the recent and projected improvement in secondary market pricing could initiate an increase in secondary market transactions in 2010.

Secondary Market Monitor

There has been some talk recently of online exchanges for secondary private equity interests. The first point to note about Preqin's new Secondary Market Monitor service is that it does not aim to do this. On the contrary, it aims to be a sophisticated information service and network to help inform buyers, sellers and advisors, and to bring them closer together. Preqin has developed the service in order to provide LPs with an idea of the value of their private equity holdings, permit them to invite bids on these holdings, and to provide buyers with deal volume. Fig. 6 illustrates the structure of the Secondary Market Monitor service in generating deal flow for both buyers and sellers of fund interests. Preqin's dedicated research teams enter market information in the form of LP investment strategies, secondary

Fig. 5:

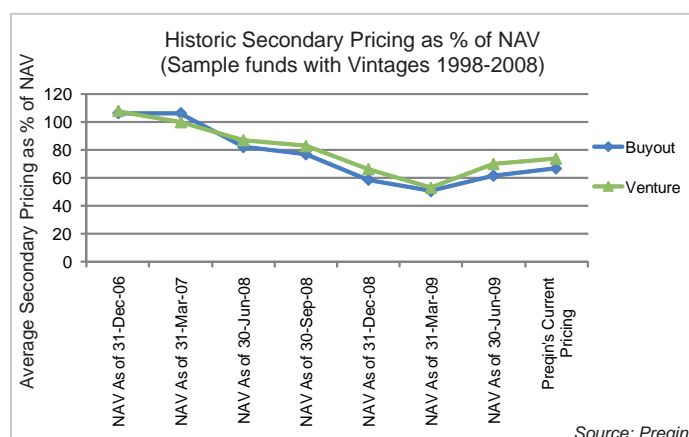
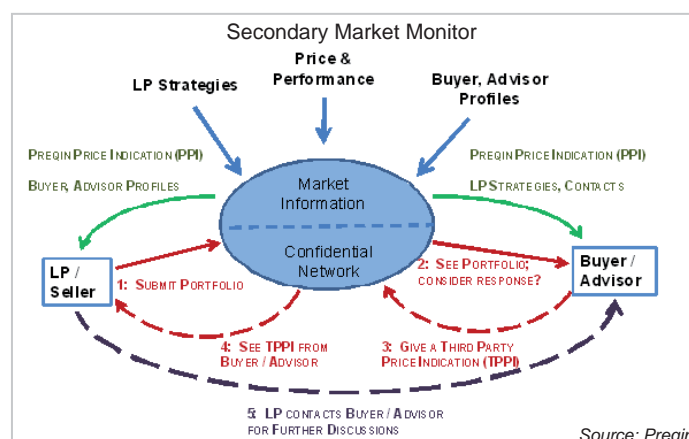


Fig. 6:



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market price and performance data, and secondary market buyer and advisor preferences. This information is then made available to the product's extensive user base, across a number of subscription levels. In addition to providing algorithmic price indications to its LP user base, Preqin's Secondary Market Monitor service also enables the user to request third party price indications (TPPIs) from secondary market buyers subscribed to the service. In this way, the service provides a confidential network through which potential buyers and sellers of fund interests can make initial contact.

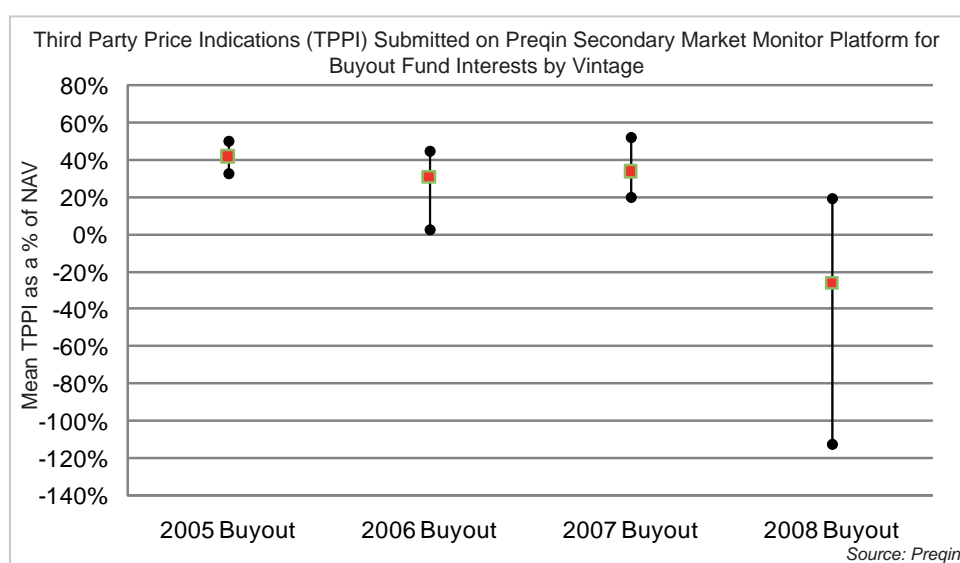
Securing the Best Price

Given the potential for accelerated deal flow in 2010, it should be noted that there are a number of ways in which sellers of private equity fund interests can secure the best price for their holdings. Secondary market investments currently represent a good deal for buyers, which has seen a wealth of non-traditional investors enter the market. This increase in demand brings with it greater variation in investment preferences and a higher degree of selectivity and specificity among the buying community. Both specialist and non-specialist secondary market buyers are known to be harbouring wish-lists, detailing specific funds in which they would like to acquire interests. It can therefore be advantageous for a seller of fund interests to subdivide their investment portfolios and repackage as a series of strategically orientated offerings. Given the apparent increase in selectivity among buyers in the market, it would also seem beneficial to invite a range of bids in order to achieve the best possible price.

Variety in Secondary Market Pricing

Fig. 7 highlights the variety in third party price indications submitted for buyout fund interests through Preqin's Secondary Market Monitor service, showing high, low and mean bids. It can

Fig. 7:



be seen from the figure that the greatest variety in bids have been received for interests in 2006-2008 buyout funds, which may highlight the importance in inviting a number of bids in order to achieve the best possible price, particularly for stakes in funds of this description. Indeed, bids received for 2006 buyout fund interests ranged from 2% to 45% of NAV, while 2007 buyout fund interests fetched bids in the range of 20% and 52% of NAV. Bids received for 2008 buyout funds have provided the most interesting case, where in some cases buyers have actually requested the seller pay for the release of their obligation to the fund. Bids for funds of this description ranged from minus 112% to plus 19% of NAV, which may reflect the inherent difficulty in valuing interests in funds which have called very little capital. The prevalence of these immature and largely unfunded secondary fund interests on the market currently has clearly been linked to the presence of non-traditional buyers in recent transactions, many of whom will see immature secondaries as an alternative to making new commitments.

Summary

In summary, secondary market transaction volume in 2009 has

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not met expectations, with estimates of just \$6bn year-to-date as of November 2009, compared with \$20bn in 2008. This may be explained by the global economic crisis and the introduction of FASB 157 reporting regulations, which have both made it difficult to accurately assess the underlying value of private equity fund interests. Preqin's research has demonstrated the close relationship between listed private equity and secondary market pricing and we have developed an indicative secondary market pricing model accordingly. By plotting pricing indications against time, it appears that secondary market pricing has been improving since March 2009, when it appeared to reach a floor. Given the sustained pressure on investors to fund their private equity investments and the projected improvement in secondary market pricing in the near future, we expect that 2010 will yield an improvement in secondary market transaction volume. Given this forecast, sellers should consider both subdividing their private equity portfolios and inviting a range of bids in order to take advantage of the selectivity which exists among secondary market buyers and maximise the price they obtain for their holdings. Preqin has developed the Secondary Market Monitor service in order to provide a sophisticated information service and network to help inform buyers, sellers and advisors, and to bring them closer together.

Calling all LPs

Keen to discover the true value of your private equity portfolio?

Preqin's Secondary Market Monitor

For a free and confidential indicative valuation
of all or part of your private equity holdings visit:

www.preqin.com/secondarymonitor

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