July 2005

Q & A WITH MARLEEN GROEN

Q: What developments have you seen on the secondary market in terms of the price of venture assets?

A: We saw the venture bubble resulting in a lot of secondaries being done at very low values. These were mainly the venture funds that shouldn't have been there or that were just unlucky in terms of timing of their investments. The ones that lost value straight away produced a lot of sellers desperate to get out and not put any more money in. That was the 2001-2002 time frame and there were major discounts to the extent that actually quite a number of deals were done where the seller had to pay the buyer to take over the outstanding commitments. Those deals have disappeared and we're now looking at secondaries of venture funds that have managed to stay alive and develop, and some of them are doing quite well. It has become a totally different proposition in terms of secondary transaction. These transactions are higher in price than the secondaries of a few years ago, reflecting the higher underlying value.

Q: Where do you seek secondary venture interests?

A: Particularly corporate groups are big sellers at the moment. We analyse every year where our sellers come from and we have seen aspects both on the venture and the buyout side. In 2002 we had a lot of corporates selling. In'03 the level of corporates selling was down, the level of banks seeking an exit up. In '04 it was very much corporates up again, banks down. The banks in 2002 were selling huge portfolios for regulatory reasons,

but that process is now by and large finished. We're now seeing the corporates selling more for strategic reasons than for anything else.

Q: Why is it good for a GP to sell a 'tail end' on the secondary market?

A: I'm absolutely convinced on both the venture and the buyout side that it makes a lot of sense for LPs in older funds. If a GP is in, say, a fund V or VI, the remaining assets in their fund III are not going to make a material difference on the returns and performance of that fund. The LPs in the older fund in most cases would like to get a check, have [the fund] wound up, and then it is officially over. Currently these tail ends are just sitting there. Many GPs think that LPs would not want to sell them this as a package. I'm not convinced of that any more. When I talk to LPs, they often confirm that they would love to have the tails wound up.

After all, 10 years is the normal life of the fund. After 11, 12 years it all gets very tired. And in any case, it's so highly unlikely that the remainder of the portfolio will move the return needle. Those tail ends should be sold as a package, which was the idea of people who over the last 10 years have tried to raise funds for this type of portfolios of direct secondaries. Their plans were aimed less at the purchase of corporate portfolios of directs. The older fund tail ends have been there for a while now, and we're slowly but firmly moving towards the direction that these tail ends are being wound up.

Q: Will we see more of these tail-end deals?

A: It's only now starting to be found acceptable by GPs. We've seen more funds of funds selling older fund holdings in their older funds of funds than we've seen GPs selling their old tail ends. Increasingly though we're seeing this type of activity. Personally, I think it should have started earlier. People have been talking about it tentatively, but there is now more action than there used to be. Keep in mind, though, that many of these tail ends are not worth very much. The argument that if something is still there after year 12 it's probably not that great holds for a lot of these companies, but not for all. The GP should in any case not keep sitting on them.

Q: Have you approached GPs about this?

A: We do regularly. GPs generally find it an interesting idea, think about it but believe that LPs wouldn't like it. That's where I believe the opinion is changing. Because LPs would actually quite frequently be in favour of it. With so many new venture and buyout funds having been raised quite successively much faster and in larger amounts then even before, LPs are now investors in an increasingly large number of funds and for some of them it is becoming unmanageable. They have to do some housekeeping and will try to reduce the number of fund lines in their books. Many LPs are reducing the numbers of managers they are invested with and they're taking a hard look at getting into new manager relationships. The least a GP could do for his investors is to clean up the older funds and help the LPs to reduce the number of funds they are in. It's a relatively recent development which we believe is gathering momentum.

Q: Will GPs become more willing to sell venture portfolios over time?

A: It's a movement that I think is happening. We can see it starting and we are discussing it with people more frequently. It's not happening in a big way yet, but then it took 10 years for the traditional secondaries market in fund positions to get as mature as it now is.

Q: Are opportunistic buyers shooting themselves in the foot by paying high prices for secondary assets?

A: It depends on why they're purchasing it. If they do it because they want entrée to a particular fund post-final closing, then it's a strategic purchase and less price sensitive. If they're doing it because the cost of capital is much lower, then their pricing is still justified. The secondaries market was always bound to become more competitive, and we are finding that it has done so in a major leap. The interest in venture in 2000-2001 has prolonged the opaqueness of the secondaries market for a few more years.

Q: How does the structure of Europe's private equity market differ from the market in the United States?

A: Overall I wouldn't say it's that different. In Germany the tax laws have been rather complicated and less private-equity friendly than some other jurisdictions. This has changes and it is now possible to implement structures that work for German and international investors. It's nevertheless still difficult for German private equity houses to get foreign investors. If not set up properly, the investors will encounter tax charges in many different ways through all sorts of laws, the workings of which are not necessarily totally clear.

Q: Will venture portfolio secondary specialists change the asset allocation of larger funds? Will that muddle the market a bit?

A: When these management-for-hire groups see a mid-size transaction they will typically go to a secondary fund for whom the deal is within their ballpark – activity, location and size-wise. That way the management group knows that they get the time and dedication they need to get the transaction done. It does not make sense to go to a very large player with a $5 million to $10 million deal. That doesn't quite work. The specialization in the secondaries market is ensuring that management-for-hire groups can approach the most suitable financiers behind such a deal and they can easily avoid taking too small a deal to too big a player or the other way around. This selective approach takes one of the many risk factors out of the potential transaction.

Q: Should venture portfolio buyers that use outside financing raise their own funds?

A: For some [firms] it makes sense. However if you can take a deal to a secondaries player who would like to work with you anyway, I wonder why you would want to spend a year or more on the road? It takes a huge amount of time to raise the fund, whereas you can spend the time working on portfolio investments and take them to the appropriate selection of secondaries players who will fund it.