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WHERE IS "THE MARKET" AND HOW CAN INSTITUTIONS ACHIEVE OPTIMAL PRICING?

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In recent years, finding a reliable gauge of pricing in the secondary market for private equity funds has been the institutional investor's equivalent of a Sherlock Holmes mystery – a guessing game to the end. Speakers at private equity conferences are inevitably asked for their insights on the subject; and to the audience's dismay, they are rarely able to give a conclusive answer.

Why the shroud of uncertainty? One culprit is a dearth of historical information about secondary transactions. Even in an industry where confidentiality is the rule, deals for secondaries may be the most closely guarded. This has remained true even as the secondary market has grown in size and importance within the private equity sector.

For institutional investors seeking to optimize their portfolios through the sale of secondary assets, estimating market value without solid data becomes little more than a shot in the dark. To realize an asset's true potential in the marketplace, portfolio managers need more information about recent secondary transactions and the range of bids received in the auction process.

This study conducted by Cogent Partners encompasses more than 100 fund interests transferred on the secondary market. While the study sheds light on current pricing levels in the secondary market, the data show that there's no such thing as a "market price." Instead, the numbers reveal several key findings that may surprise and enlighten the institutional investing community:

1. The range of secondary bids received for each fund interest was extremely wide.
2. The highest bids consistently disproved the common perception that all secondaries sell at discounts.
3. Engaging a diverse range of carefully selected bidders in a competitive auction process increases the likelihood of obtaining the highest price.

As institutional investors consider accessing the secondary market, the following discussion provides an in-depth look at the widespread bids the market presents, the reasons behind the disparity, and its implications for sellers of secondary assets.

Data Sample

This study analyzes a total of 659 bids that Cogent Partners received on 105 funds marketed and sold by the firm in the first half of 2005. The funds sold represent a broad range in fund types (30 buyout funds, 61 venture funds, and 14 other funds), maturities (46 funds over 70% called, 10 funds 51%-70% called, and 5 less than 50% called), and geographic locations (83 North American funds, 9 European funds, and 12 funds from ROW). The bids analyzed were received in the first round of a two-stage auction process, and the sample is limited to funds where pricing was obtained for each individual fund, rather than on an aggregate portfolio basis only. In cases where bidders submitted a pricing range in lieu of specific numbers, the mid-point of the range was used in the analysis.

The bidders in the analysis represent a spectrum of investors participating in the secondary market, such as secondary funds, primary fund of funds, pensions, endowments, and family offices.

It is important to note that the first-round bidders were given the same set of information on which to base their bids: financial statements, capital account statements, and (in most cases) fund guidance from conference calls with Cogent and the funds' general partners.

Critics may argue that first-round bids are misleading; either upwardly biased in the bidders' attempts to gain access to the second round, or irrelevant in their non-binding nature. But in fact, the final transaction price for each fund took place at or extremely close to the highest first round bid (or, for transactions yet to close, a purchase and sale agreement has been executed at this level).

Bids Show Strong Demand in Secondary Market

As shown in Figure 1, the average high bid (the simple average of the highest individual bid received for each asset) across all assets in the sample was 110.2 percent of the net asset value (%NAV) reflected on the most recent fund financial statements, with an average median bid of 88.5%NAV and an average low bid of 61.1%NAV. The buyout funds in the sample priced substantially higher than venture funds, with an average high bid of 155.5%NAV versus venture's 89.4%NAV.

Limitations of %NAV

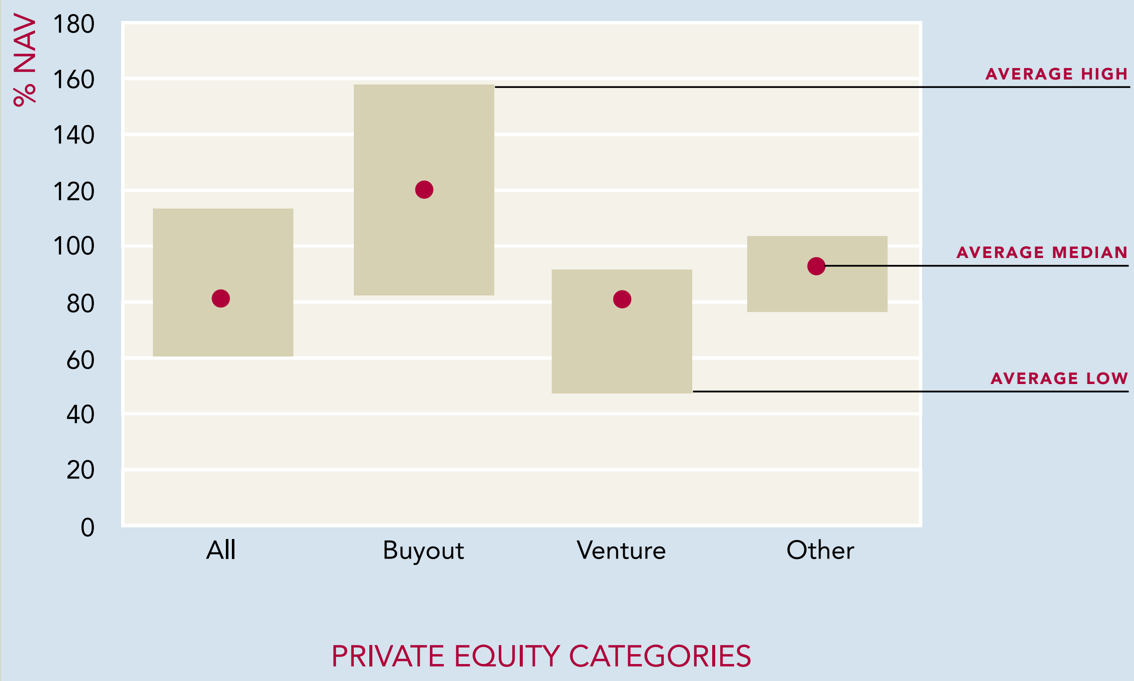
In the private equity secondary market, pricing is most frequently quoted as a percentage of net asset value (%NAV). But %NAV is of limited value when used as a gauge of overall pricing levels.

Large differences in funds' valuation policies, funding levels, and investment types will lead to large differences in pricing as a percentage of NAV. For that reason, %NAV is only a useful metric when all of these factors are very similar for the funds being compared.

A more accurate metric to gauge pricing for secondary transactions is the underwriting rate used to discount the expected cash flows for the funds. At Cogent Partners, we call this metric the **"secondary return rate."**

Nevertheless, pricing as %NAV is valuable for the purposes of this study. It aids the analysis and interpretation of the widespread bids, and helps demonstrate the attractiveness of the transacted assets.

FIG. 1 Secondary Bid Spreads (1H2005)



Buyout Pricing Explained

Such strong pricing for the buyout assets is partly a result of the maturity and quality of assets represented in the sample – twenty-six of the thirty buyout funds in the analysis were over 70% drawn.

But another underlying reason for the high bids may be less apparent. Since most buyout funds have conservative valuation practices, the intrinsic value of a mature fund often differs significantly from its book value (NAV). In other words, the funds may be worth more in reality than they are on paper.

The bidders derive their optimism from two key sources. If all is going according to plan, over time each of the buyout fund's portfolio companies will have paid down its debt and increased revenue and margins. However, this growth in equity value is generally not captured on a fund's financial statements until a liquidity event occurs. Similarly, by this stage in a fund's life, the general partners are likely aggressively seeking realization options, and can give potential buyers substantial visibility into near-term liquidity. For these reasons, bidders may see value in the tea leaves that cannot be accounted for through traditional financial analysis.

Venture Pricing Explained

When compared to bids for buyout funds, venture assets in the sample were priced less aggressively relative to reported NAV. But the real news for venture is that these bids came in much higher than the generally accepted (though anecdotal) reports of extremely depressed pricing levels. Put simply, venture appears to be making a big comeback, especially when compared with transactions from eighteen months ago.

Several factors have significantly improved secondary venture valuations as a percent of NAV. First, venture valuations are more realistic than in the days of "irrational exuberance." Most companies originally financed during the venture bubble have either disappeared or raised an additional round of capital, remarking them at more appropriate valuations. Additionally, the venture funds transacting today are more mature than those of two years ago. In the past, the notoriously low pricing for secondary venture funds was largely a result of the relative immaturity of the funds being sold. As the bubble burst, sellers were cutting their losses while they still could.

As the sample shows, today's venture transactions tell a different story.

Pricing Spreads Are Extreme

Perhaps even more noteworthy than the average high bids are the disparate spreads of the bids. Even in openly competitive situations with equal information supplied by the seller's intermediary, bids for secondary assets were, quite simply, all over the map.

Across all 105 assets, the average spread between the high bid and the low bid (again, measured as a percent of NAV) was 49.1 percentage points. The spread between the median bid and the high bid was 21.7 percentage points.

In our sample, examining the spreads by asset class provides counterintuitive data. While buyout funds are arguably easier to value from financial statements than venture funds, the buyout funds produced the larger spreads of the two classes (High-Low bid spread of 73.3 percentage points for buyout versus 41.8 for venture; High-Median bid spread of 34.6 percentage points for buyout versus 17.4 for venture).

This unexpected result is due to the limitations of examining only the gross NAV spreads. This method does not indicate the relative impact that overall pricing has on the spread. Essentially, as overall pricing on a fund is lower, the spread of the bids appears more dramatic. For example, when a fund is pricing at 20%NAV, a spread of only 10 percentage points increases the price by 50 percent.

Taking a Different View

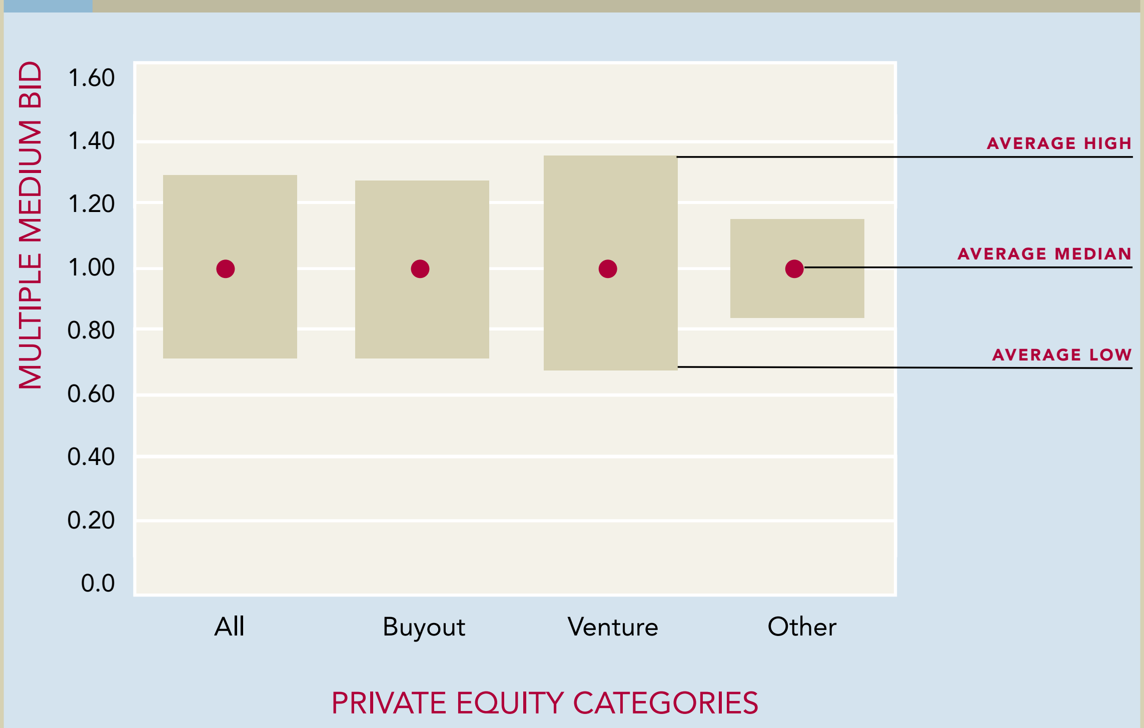
To normalize for this effect and create a relative spread metric, each bid was recast as a percentage of the median bid received for the same fund. Using this normalization factor (seen in Figure 2), the average high bid for the entire sample was nearly 130% of the median bid, with an average low bid of 69% of the median.

When analyzed as a percentage of the median bid, the spreads of buyout and venture bids come closer to expectations. Pricing for buyout funds are indeed more congruent than for venture, likely due to the bidders' increased visibility into a portfolio's value and cash flow. As shown in Figure 2, pricing for buyout assets remains remarkably scattered nonetheless, with a high bid average of 126% of the median bid and a low bid average of 70% the median bid.

Odds for Favorable Pricing Increase with Number of Bidders

The dispersion of the bids provides insights into the composition of buyers in the marketplace. As the data shows in Figures 3-5, most bids came close to the median bid received, with more than half of the bids falling between 90% and 110% of the median bid received for the fund. This median-focused distribution is consistent across all asset classes, though venture funds did experience more outlier bids at over 150% of the median.

FIG. 2 Normalized Price Bid Spreads



The results of this study are demonstrative of the value created by a well-run competitive transaction. Sellers often question the strategy of bringing numerous potential buyers into a process, believing that only two quality bidders will ultimately drive to the "market price." The numbers tell us differently.

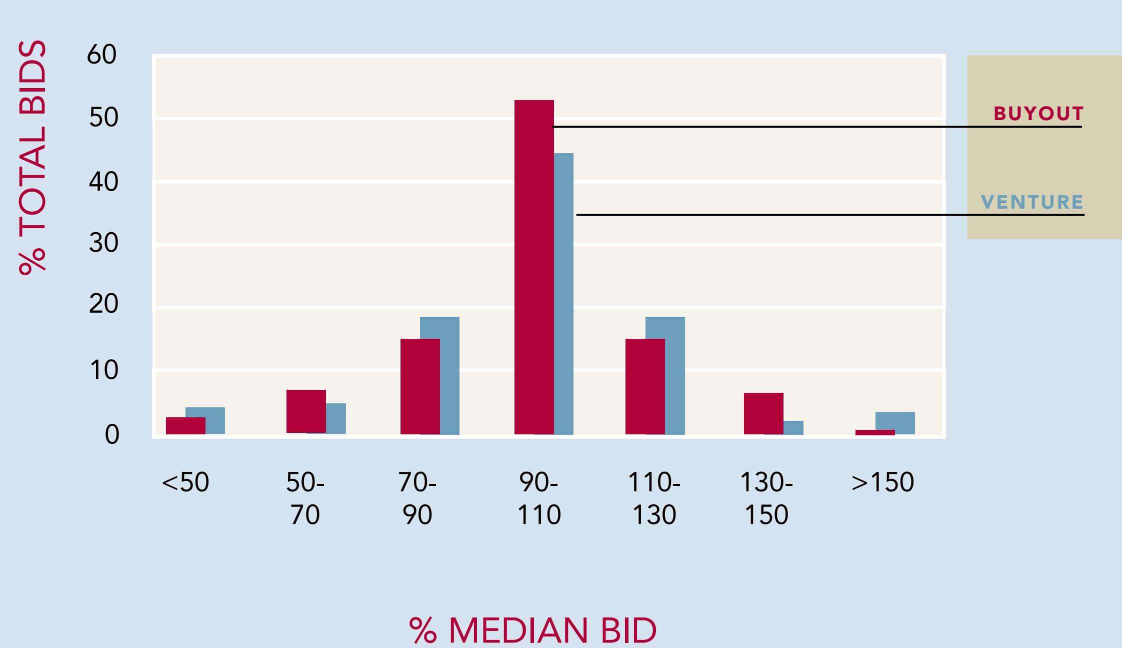
Although the average high bid was 130% of the median bid, the chances of achieving that level of pricing with only one or two bidders is small. In this sample, there is only a 20% probability that any single bid will be more than 110% of the median. By engaging a second bidder, those odds of exceeding 110% of the median improve only modestly, to 36%.

The lesson here is that while most potential buyers submit rather predictable bids, increasing the number of bidders in the process increases the chances of receiving an outstanding price.

Some investors speculate that disparate bids result when current investors in a fund are better informed than other bidders, using their "insider" status to gain an advantage. This is unlikely, however, because most limited partners (even current investors in a fund) do not capture or process information on portfolio companies over and above what the general partners supply to all auction participants.

Another possible explanation for the wide bid spreads comes from bidders' varying interpretations of blind pool risk. In Figure 6, the effect of blind pool risk on pricing is analyzed by grouping the funds by their percentage called.

FIG. 3 Secondary Market Bid Distribution



Diverse Viewpoints Drive the Spreads

So why do some potential buyers bid so much more than others? The answer can be found in their varying perspectives.

Pricing of private equity secondary interests involves valuing the invested assets, estimating a realistic return given the risk level of the assets, and assessing the blind pool risk associated with uncalled capital. Different bidders, however, interpret the information in different ways.

Effects of Blind Pool Risk on Buyout Funds

For buyout funds, the data does not support an assertion that different perceptions of blind pool risk create wide bid dispersion. Though admittedly a small sample, the four funds between 50% and - 70% called had an average high bid of 130.5% of the median bid, while funds more than 70% drawn had a high bid of 125.2% of the median bid. Interestingly, the average low bid for the more-drawn funds was weaker (68.3% of median) than the low bid for the less mature funds (81.7% of median).

The stronger average pricing (as %NAV) of mature funds may indicate that low bidders submitted less-informed, "rule of thumb" bids. These bids, which rely on a straight percentage of NAV rather than true valuation models, would prove especially off-market for funds offering good insight into intrinsic value above the reported net asset value. The similarity in average low bids across the two groups (82.1% and 82.2%) strengthens this explanation.

If blind pool risk was a major contributor to pricing spread, one would expect the pricing spread to tighten as the amount of blind pool risk in an asset was reduced. For these buyout funds, however, the opposite is true. For funds between 50% and 70% called, the difference between the average high bid and average low bid was 48.8% of the median price. Funds over 70% drawn had a high bid to low bid spread difference of 56.9% of the median bid.

Effects of Blind Pool Risk on Venture Funds

The data for venture funds leads to different conclusions. For venture funds under 50% drawn, the average high bid was 230% of the median bid received for the fund. Again, the wide range may be explained by the differing perspectives of the bidders. Principal investors who don't specialize in secondary transactions are more likely to view the uncalled capital as they would any private equity investment, and bid based on the value of the assets. Secondary specialists, however, may apply a discount to the current bid that equalizes their required return from the uncalled capital and the return projected for the fund manager.

Furthermore, primary investors are likely to bid more for venture interests from funds with access constraints, viewing the secondary purchase as a way to reserve their seat at the table for future opportunities in the fund.

Blind pool risk does appear to significantly affect pricing spreads for venture assets. The high to low spread for the small sample of venture funds less than 50% drawn is 185.2% of the median bid received. The high to low spreads for funds 50%-70% and greater than 70% called are 63.6% and 58.7% of the median bid received, respectively.

More mature venture funds also demonstrate spreads more in line with buyout funds, with average high bids of 127.7% of the median bid for funds 50%-70% drawn, and 126.3% of the median bid for funds greater than 70% drawn.

A Thorough Auction Process is Essential

From an abundance of data and analysis comes one striking realization: when determining what the market will bear for secondary private equity assets, it depends on who you ask.

Despite the fact that the bids in the sample were collected in an openly competitive process; despite the fact that all bidders had access to standard information and asset insight from sell-side representation; and despite the fact that all bidders were qualified institutional investors making presumably aggressive bids, the range of prices presented for secondary assets remains exceptionally wide.

FIG. 4

		No. of Funds	Avg High	Avg Low	Avg Avg	Avg Median	Avg Hi-Low	Avg Hi-Median	% of Median Avg High	% of Median Avg Low
% of NAV	All	105	110.2%	61.1%	87.1%	88.5%	49.1%	21.7%	129.6%	69.2%
	Buyout	30	155.5%	82.2%	120.1%	120.9%	73.3%	34.6%	125.9%	70.1%
	Venture	61	89.4%	47.6%	70.2%	72.0%	41.8%	17.4%	135.0%	65.8%
	Other	14	103.4%	74.4%	90.0%	90.6%	29.0%	12.9%	114.2%	82.4%
Venture by % Called	<50%	5	78.9%	23.0%	54.3%	57.2%	55.8%	21.6%	230.8%	45.6%
	50-70%	10	88.8%	53.8%	71.7%	73.3%	35.0%	15.5%	127.7%	64.1%
	>70%	46	91.5%	49.3%	72.2%	74.1%	42.2%	17.4%	126.3%	67.6%
Buyout by % Called	<50%	0								
	50-70%	4	131.3%	82.1%	103.8%	100.6%	49.1%	30.7%	130.5%	81.7%
	>70%	26	159.2%	82.2%	122.6%	124.0%	77.0%	35.2%	125.2%	68.3%

As institutional investors seek to obtain optimum pricing for their secondary assets, they may draw several valuable conclusions from this study:

The market for secondaries is strong, but there is no substitute for the value of a competitive process when running a secondary transaction. Given the extremely broad range of bids in the auction process, it is highly unlikely that engaging only one or two buyers will yield the highest possible price.

The data also underscores the value of a carefully chosen pool of bidders with differing approaches and investing motivations. Allowing a diverse array of prospective buyers to evaluate the assets generated an incremental 29.6% of potential value above the median bid for each asset. In the most convincing case, the average high bid for immature venture was an incredible 230.8% of the median bid.

With these thoughts in mind, institutional investors can enter their next secondary transaction with a seasoned approach and a sense of renewed optimism.

Cogent Partners *has advised institutional investors on over $6.5 billion of private equity secondary transactions since the firms' founding. Through its research-driven, analytical approach to the secondaries market, Cogent Partners works with clients to achieve their objectives and fulfill their fiduciary duties.*

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