Take Note

SECONDARIES

Second-hand assets, first-rate opportunities

The market downturn is creating unprecedented opportunities in the private equity secondary market, which is now estimated to be at around US$140 billion[1]. Pantheon, a global leader in the market, has invested more than US$5 billion[2] across a number of economic cycles over more than 20 years. In this Take Note we share our insights on this market and on the key factors that influence a secondary transaction and look into the future of secondary investing.

The market for secondaries

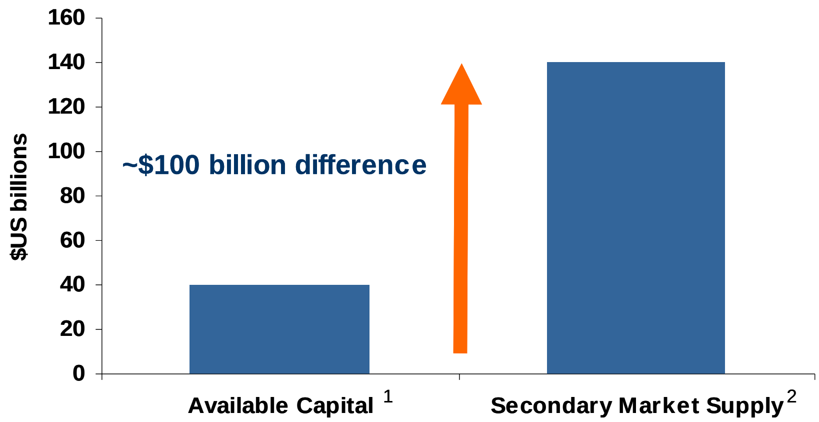
In the early days of the secondary market, there were vendor and General Partner concerns attached to selling private equity interests. But the market experienced a huge amount of deal flow after the tech boom, when stressed sellers needing liquidity provided the impetus for the market to grow to about 3-5%[3] of the primary market. The market also benefited from the increased capital adequacy requirements for illiquid assets held by financial institutions, which prompted a rash of sales.

These two drivers of growth in the market – liquidity-driven selling and regulation – have been joined in the last few years by a third, "portfolio management", where many institutions and pension funds increasingly use the secondary market to rebalance portfolios of existing private equity assets. By 2007, the secondary market had a broad range of buyers and sellers, with increased levels of sophistication. Growth in the secondary market had kept pace with the huge expansion in the primary market and the reservations associated with secondary sales had disappeared.

The unprecedented recent market dislocation has created a tidal wave of liquidity-driven sellers, on a scale not seen before in the secondary market. These highly motivated sellers include financial institutions which have severe balance sheet pressures and overstretched institutional investors struggling to meet funding obligations and dealing with the denominator effect.

This latest wave of sellers has created a huge imbalance between supply and demand, which Pantheon estimates at some US$100 billion as illustrated in the chart on the next page. Pantheon has already seen deal flow of some US$15 billion[4] this year and more than US$45 billion[4] over the last 12 months. This imbalance, together with the uncertainty about underlying asset values, has contributed to lower prices and the ability for buyers to be highly selective in the assets they are willing to purchase.

The Gap Between Supply And Demand



[1] "Available capital" amount aggregates estimated fund size for 16 secondary groups reported by Preqin to be fundraising as of February 2009 based on publicly available information. Actual capital available in the secondary market may be materially different.
[2] Source: Reuters, "RPT – Private equity deals at five-year low"; December 22, 2008.

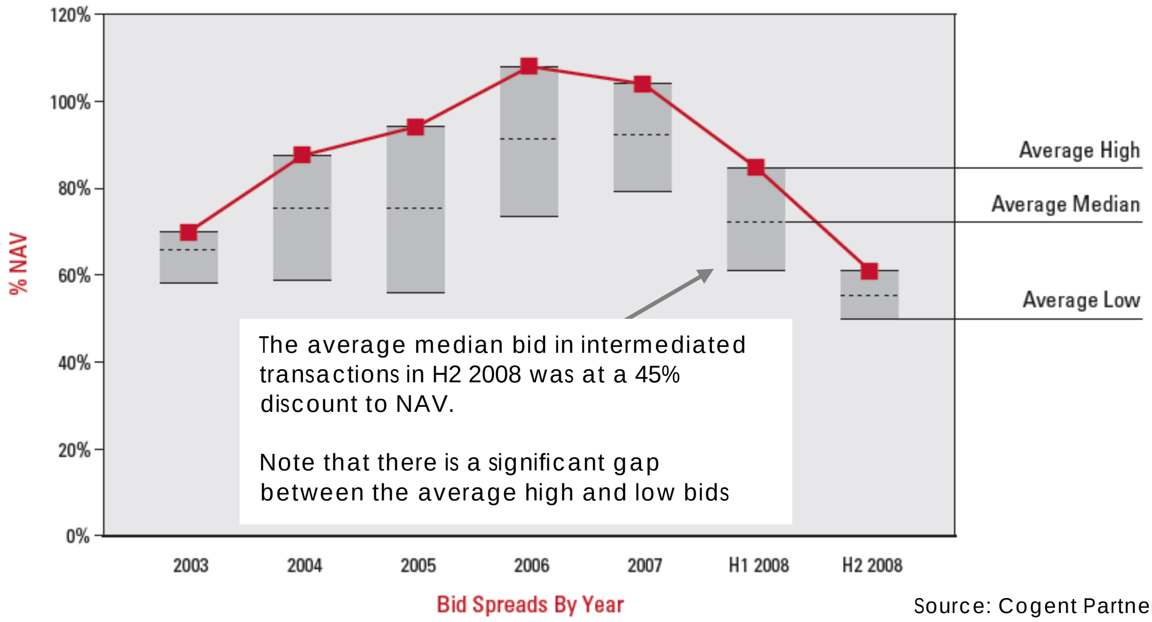
Pricing: Heavy discounts not yet clearing the imbalance

The purchase price in a secondary transaction is generally based on the fund's latest reported net asset value ("NAV") and expressed as a discount or premium to that NAV. Private equity funds only report on their NAVs on a quarterly or half-yearly basis and in times of more volatile stock markets private equity NAVs quickly become outdated. Pricing in the secondary market reflects not only the buyers' expectation of any revisions to the NAV, but also the longer term cash returns from the fund. The latter takes into account expectations of the economic and business outlook for the companies and the time period until exit.

Typically prices are at a discount to NAV. However, from 2005 to 2007, when stock markets were very buoyant and exits were achieved in shorter time frames, many buyout funds traded at a moderate premium. This was also a period where we saw secondary buyers adding leverage to the purchase structures to compensate for higher prices. Unsurprisingly, pricing dropped through 2008 as the supply of secondary interests started to outstrip demand and as the sentiment for private equity investments deteriorated.

The chart on the next page shows the trend in prices over the past few years. In reality, the pricing spreads for an individual asset can be quite wide, reflecting the knowledge and the judgement of the buyer. At Pantheon, we have seen, and bid at, higher discounts than the discounts shown in the chart, explained by our high proportion of proprietary deal flow. In the first quarter of 2009, almost half of Pantheon's deal flow was direct from sellers or General Partners. This high percentage of proprietary deal flow means there is lower risk of overpaying for assets and greater flexibility in tailoring a solution for the seller.

Secondary Pricing as a % of NAV



Source: Cogent Partners
Data is historical and not indicative of future results.
As of 4O 2008

This is now clearly a buyer's market and discounts of around 60% are commonplace. Less mature funds (sometimes referred to as "early secondaries" or "late primaries", where there is little money invested) are trading at even wider discounts, as the key motivation of the seller is to eliminate the unfunded commitment. This motivation need is proving to be a significant driver of current deal flow.

Despite strong deal flow, the number of deals actually being completed remains relatively low. This is largely due to the mismatch between buyer and seller pricing expectations and uncertainty over the effects of the recession on underlying company performance. December 2008 valuations now reflect some of the downward movement in stock market valuations. However, there is still widespread expectation that values will continue to decline as the slowdown in operational earnings and the impact of leveraged structures take effect.

Key factors that influence a secondary transaction

There are many factors that influence a secondary transaction and we have already discussed the demand/supply balance, the maturity of the fund and the seller's motivation. In addition there are three areas that will determine the preferred buyer of the assets and the price paid:

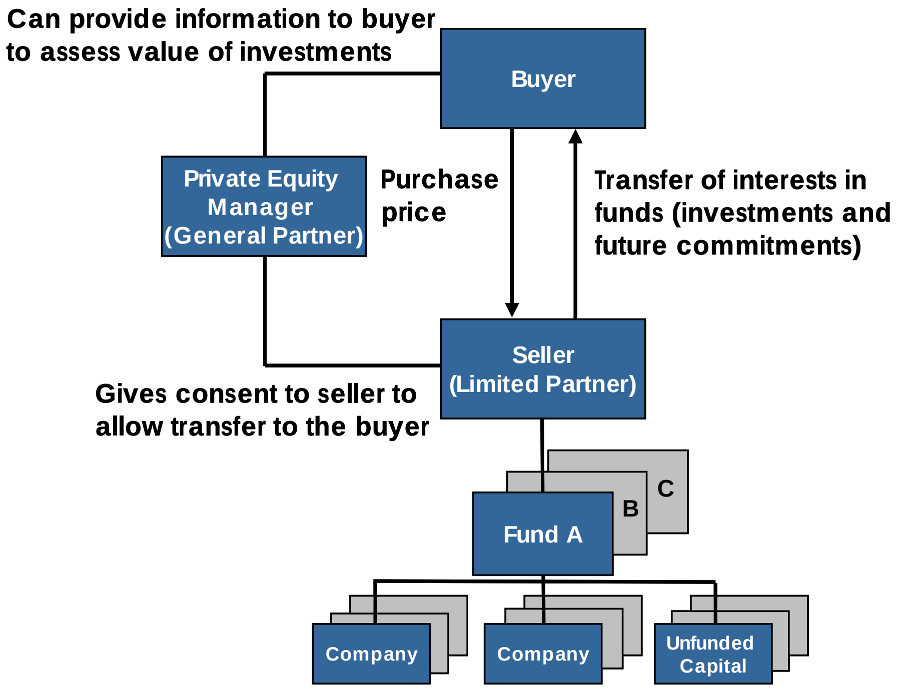
- Influence of the General Partner;
- Due diligence of the buyer; and
- Structuring of the transaction.

Influence of the General Partner: High quality investor needed

While the seller is generally motivated to receive the highest price, the General Partner's motivation is to replace the seller with a high quality and long term investor and to ensure the transfer process is as efficient as possible. Many General Partners take an active role in the process, in order to maintain control of the shape of their investor base. In addition, some General Partners will draw up a restricted list of buyers whom they will consider. Clearly, buyers who are already investors and who could also be future investors in the next fund are preferred, which favours buyers with the potential to provide primary capital, such as Pantheon. Often, if the General Partner hears of an interest for sale, they will approach a preferred buyer who is generally already a Limited Partner. This facilitates the sale process and because of embedded knowledge, the buyer can move quickly with prior approval of the General Partner.

The chart below shows the most typical kind of secondary transaction whereby a seller transfers an interest in a fund, or more commonly a portfolio of funds, to a buyer. The larger the number of funds, especially when the funds are domiciled in different geographies, the more complex the transaction becomes both in terms of valuing the assets and in ensuring an efficient transfer of the interests.

Secondary Transaction: Sale of Private Equity Funds



Due diligence of the buyer: Access to information is a key advantage

The focus of a buyer's due diligence is on the quality of the manager and the assets. This will be a mixture of both quantitative and qualitative due diligence. At Pantheon, we construct a tailored model for each transaction building on our own proprietary knowledge of the portfolio companies, further enhanced by up-to-date information obtained from each General Partner. This will start with in-depth analysis of the underlying companies within the portfolio, looking at the strength of operating earnings, capital structure, debt profile, comparable company valuations and timing of a sale. Cash flows will be estimated for each of the underlying companies and sensitivities applied to these, depending on the specifics of the portfolio. For example, if there is a high proportion of consumer cyclical companies in the portfolio, a sensitivity test regarding the exit proceeds may be added. Examples of our analysis are shown below.

In-depth Analysis of the Portfolio Companies and Sensitivity Scenarios[5]

	Company	Fund	Public / Private	Company Description	Debt Profile/Exit Rationale
1	Company A	Fund D	PRIV	Cable operator	~Operating results were strong for 2007. Significant progress has been made upgrading the fibre network. In addition, further investment has been made in both customer service and advertising. EBITDA was up 20.4% for the year. Net debt is at 6.5x EBITDA. ~March 08: Company valued at a discount to a new third party investment. €800m returned to date. Due to significant realization and valuation write up to date, assume 1.5x current NAV (this would result in a total 8.2x
2					

Fund H

Company	EBITDA Vulnerability to Downturn	Capital Structure Risk
Company A	H	M
Company B	M	M

Fund C

Company	EBITDA Vulnerability to Downturn	Capital Structure Risk
Company A	M	M
Company B	L	L
Company C	L	L
Company D	M	L
Compa		

Fund A

Company	EBITDA Vulnerability to Downturn	Capital Structure Risk
Company A	L	L
Company B	L	L
Company C	L	L
Company D	L	L

Company B – Fund D (Private)

Acquired: xxx 2005
Cost: €232.2m
Realized Value: €363.2m
Current Value: €616.5m
Projected Exit Value: €709.0m in 2010
Exit Value to LP: €3.64m (3.79% of total proceeds)

Company B - Financial Performance

(in €m)	2005	2006	2007	LTM June 08
Revenue	2,286.0	2,512.0	2,800.0	2,890.1
EBITDA	645.0	710.0	864.0	879.7
Net Debt	3,517.0	3,229.0	3,908.0	3,763.4

Description: Company B provides technology and distrib tourism industry. The company operates the following main systems that is an interface between travel content providers a it offers an IT outsourcing solution for airlines' in house IT sy powers online travel technology and corporate travel man majority stake in ZZZ, an online travel agent.

Debt: Net debt stands at €3.8 bn at June 30th 2008.

Recent Financial Performance: In the last 12 months to Ju business lines are performing well. Through August the comp but the management is preparing for the softening in the mark through gaining market share and overall industry growth. Th company is approximately estimated at 35%. GDS business i expected to be impacted by lower air passenger travel in the n

Outlook/Exit: Exit assumed in 2010 at a slight uplift from cu in an overall return for the fund of 4.6x cost.

PROJECT XYZ - SENSITIVITY ANALYSIS

	IRR	Effective Multiple
Pantheon Base Case *(@ 55.9% discount)*	**29.0%**	**1.91x**
Reduce Cash Flows by 20%	19.2%	1.59x
Delay exits by 1 year	20.3%	1.91x
Reduce exit proceeds to zero of all consumer discretionary companies	18.0%	1.54x
Reduce exit proceeds by 50% for top 5 companies	19.1%	1.56x
Reduce exit proceeds by 50% for top 10 companies	11.6%	1.33x
Reduce companies w/ leverage >5.0x EBITDA to zero	10.2%	1.27x
Reduce companies w/ leverage >5.0x EBITDA and consumer discretionary companies to zero	0.3%	1.01x
Assume all companies invested in 2006 and 2007 return 0.5x NAV	20.7%	1.58x
Company Specific		
Delay Company A exit by 1 year	28.0%	1.91x
Reduce Company B and Company C proceeds to zero	20.6%	1.61x
Break-even Point		
Reduce Cash Flows by 53%	0.3%	1.01x

For illustrative purposes only

Analysis of value also needs to include assessment of the quality of the manager, for their ability to manage the existing portfolio companies but also to invest the unfunded capital sensibly. This analysis is closer to "primary" style due diligence which is more qualitative, focussing on the quality of the management team, deal sourcing capabilities, competitive positioning, strategy, team structure and incentives. At Pantheon, the secondary team works closely with the primary teams in each region to assess the quality of the General Partner and the fund. Once both the funded and unfunded components are analysed, a fund analysis is completed, taking account of all fees to the General Partner. From this a portfolio valuation is derived with the appropriate discount rate.

Key to both the quantitative and qualitative analysis is the quality of information about the companies and the General Partner. Pantheon, as an investor for 25 years, has investments in over 1,000 funds across the globe and a deep knowledge and experience to draw upon.

Combined with this, Pantheon has strong relationships with the General Partner community and is represented on more than 180 advisory boards worldwide.

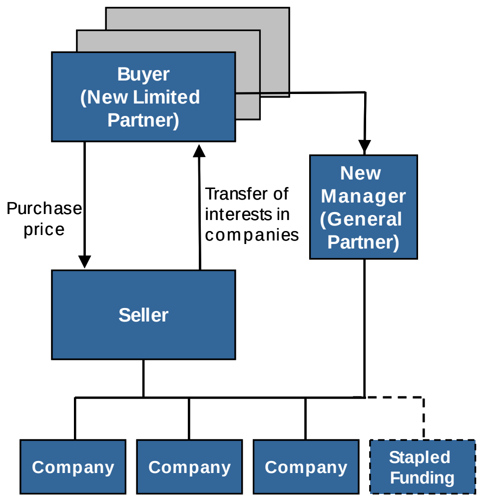
Structuring: Driving innovation and tailor-made solutions

Reflecting the broad range of transaction and vendor requirements, innovative deal structuring has become increasingly important. An acquisition of a large portfolio of funds often involves complex legal and financial structures in order to satisfy the requirements of both the vendor and the buyer. A credible buyer has to deal with a number of technical issues, including the set up of special purpose vehicles, the negotiation of deferred payment structures as well as dealing with multiple geographies and currencies.

Over time, a broader range of transaction types has evolved. Each of these transaction types is a modification on the plain “vanilla” portfolio secondary transaction but generally requires a tailor-made solution to a unique set of assets or problem.

The best known alternative structure is called the secondary direct, where a new General Partner is formed around a group of existing assets (see diagram below). Sometimes the transaction is “stapled”, whereby the sale of the existing assets is tied to the provision of primary capital to the new manager.

Secondary Direct Transaction: Sale of Direct Interests in Companies



Key differences between Fund purchase and Secondary Direct:

- Tailor-made solution limits competition
- Manager untested in fund environment
- More complex due to formation of new general partner arrangements

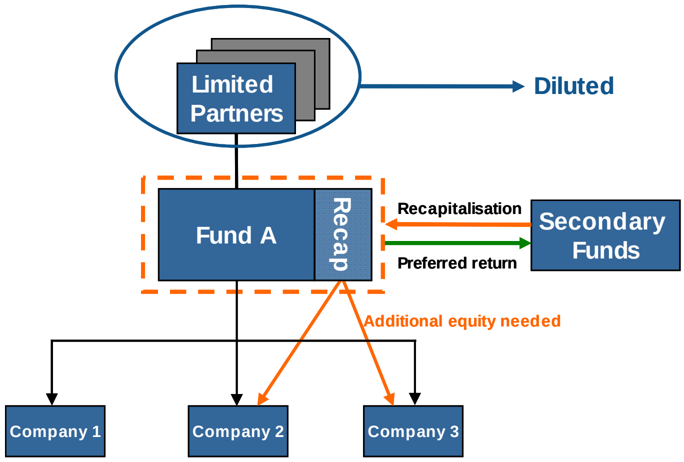
Unlike the purchase of fund interests, there is no General Partner to provide consent to the transfer – as this is a new fund formation. For this reason, participants in the market without primary capabilities tend to favour secondary directs and need to factor in a higher discount rate due to increased risks associated with a new manager.

Structuring transactions with leverage or securitisation also became popular, particularly in 2006 and 2007, to cater for fuller asking prices. Given lower current risk appetite and availability of debt, these transactions are also now out of favour. Instead, buyers are focusing on structures that protect the downside in the transaction. Such deals enable buyers to take advantage of the high level of deal flow but minimise the risk associated with further economic uncertainty. An example of such a transaction is set out on the next page.

Case Study: Structured transaction to limit downside risk

The transaction and deal structure

- Fund A has a limited amount of capital left to support existing portfolio companies, some of which may be at risk of default or failure if no additional funds are available.
- Pantheon implemented a structured transaction where secondary funds provided additional capital in exchange for a preferred return (all cash returns from Fund A companies accrue to the Secondary Funds until a hurdle rate is achieved).
- The existing limited partners accepted dilution in order to optimise the returns from the fund.



The Pantheon advantage

- Ability to do the legal and financial structuring of the transaction (including downside protection through preferred return);
- Ability to execute the deal smoothly and efficiently;
- Existing relationship with General Partner;
- No conflicts of interest, as Pantheon was an investor with the General Partner, but not in Fund A;
- Ability to analyse assets.

The future of the secondaries market

The secondary market is now well established as a viable and proactive means of gaining liquidity and managing portfolios of private equity. It is set to grow and we expect it to become a still more significant part of the private equity arena over time.

The range of assets that are considered potential targets for secondary acquisition will continue to expand. One such area is infrastructure, where the recent stress in financial markets has led to the emergence of motivated sellers of secondary interests in infrastructure funds much earlier than expected.

The number of firms that look to buy in the secondaries market is likely to grow to take advantage of the expanding opportunity set, although those firms that can leverage on strong primary teams will be best placed to select the superior deals from the abundance of assets on offer. Only large players with global teams and in-depth knowledge of the funds are likely to be able to price in all conditions and provide tailor made solutions for more complex and larger transactions.

Present levels of deal flow should be sustained over the next few years and, for those with capital to invest, there will be some very attractive opportunities to buy quality assets at a significant discount to fair market value. The price gap between buyer and seller is expected to close and experienced players will be able to make very sound investments in this cycle.

Notes:

[1]As at December 2008

[2]As at 1st April 2009

[3] Sources: The Deal, October 2007; Morgan Stanley – "An evaluation of trends in the secondary market for private equity" 2008, LCD European Private Equity, July 2008

[4]As at 31st March 2009

[5]Samples of Pantheon's proprietary model