

Secondary Market Barometer

Look Back (Q2 2009)

Transaction Volume ▼
Pricing —
Bid/Ask Spread —

Look Forward (Q3-Q4 2009)

Transaction Volume ▲
Pricing ▲
Bid/Ask Spread ▼

Key Secondary Contacts

Craig Marmer, Partner
cam@probitaspartners.com

Anita Gonzalez, Principal
amg@probitaspartners.com

Chris Mayo, Principal
cfm@probitaspartners.com

Chike Agbai, Vice President
caa@probitaspartners.com

www.probitaspartners.com
secondary@probitaspartners.com

PSG SECONDARIES
GROUP

Probitas Second Thoughts Secondary Market Survey

Preface

With this issue, Probitas Partners Research begins to publish a quarterly newsletter, *Second Thoughts*, covering issues, ideas and market updates on the alternative assets secondary market.

The scope of *Second Thoughts* is to offer intelligence on current and emerging trends in the secondary market which will include such topics as pricing and marketing trends, transaction volume and market outlook, to assist institutional buyers and sellers of positions to make the best investment decisions.

Introduction

During spring 2009, Probitas Partners conducted an online survey of alternative asset limited partners and how they perceive the current secondary market. We received responses from 391 senior investment executives representing a wide range of institutional investors.

The survey included investors responsible for private equity, real estate and infrastructure funds. Many alternative asset investment professionals are responsible for all three of those asset types.

Summary of Findings

- **Though investor portfolios are under stress, with 61% at or over target allocations, only 10% of respondents were seeking to decrease exposure.** At this point, many investors are looking to manage their allocations by slowing the pace of new investments or allowing allocations to temporarily exceed targets instead of turning to the secondary market.
- **Fifty-nine percent of respondents feel that sellers' price expectations are too high and 39% feel that general partners are still overvaluing assets.** The combination of these and other factors have led to the wide bid/ask spreads that have stalled sales since late Q4 2008.
- **Buyers of secondary interests are interested in middle market buyout and growth capital strategies, and are quite averse to mega buyouts.** Consistent with interest we see as an advisor, buyers are more focused on the smaller end of the market, where it is perceived that less leverage was used at the portfolio companies and lower purchase multiples were paid.

Profile of Respondents and Definitions

The survey targeted institutions that invest in buyout, venture capital, growth capital, mezzanine, distressed debt, real estate and infrastructure funds as well as fund-of-funds and secondary funds. For this newsletter we are using the term "alternative assets" to describe these assets as a group. Also, mega buyout refers to buyout funds with more than \$5 billion in commitments, and middle market/large buyout refers to funds with \$1 billion to \$5 billion in commitments.

Fund-of-funds managers represented the largest group of respondents, accounting for 27% of the sample, while secondary fund managers accounted for 6%, forming on a combined basis a “specialist” category that represented 33% of the total. Public pension plans made up the second largest group at 14% of the sample, with family offices and endowments & foundations each at approximately 10% of the total.

Geographically, 63% of respondents were headquartered in North America, with 26% headquartered in Europe, and most of the remaining respondents headquartered in Asia.

Most respondents were also fairly experienced, with 90% active in alternatives for three years or more, and over 38% active for 15 years or more. Eighty-seven percent of the respondents focus at least in part on private equity; 35% focus at least in part on real estate; and 25% focus at least in part on infrastructure.

All questions relating to potential secondary transactions asked respondents to assume “the fund(s) is/are highly drawn down.” This assumption was used to eliminate the effect of pricing on highly unfunded positions, which currently represent a meaningful portion of the secondary market but for the most part are trading at modest pricing levels.

The following pages discuss key results of the survey.

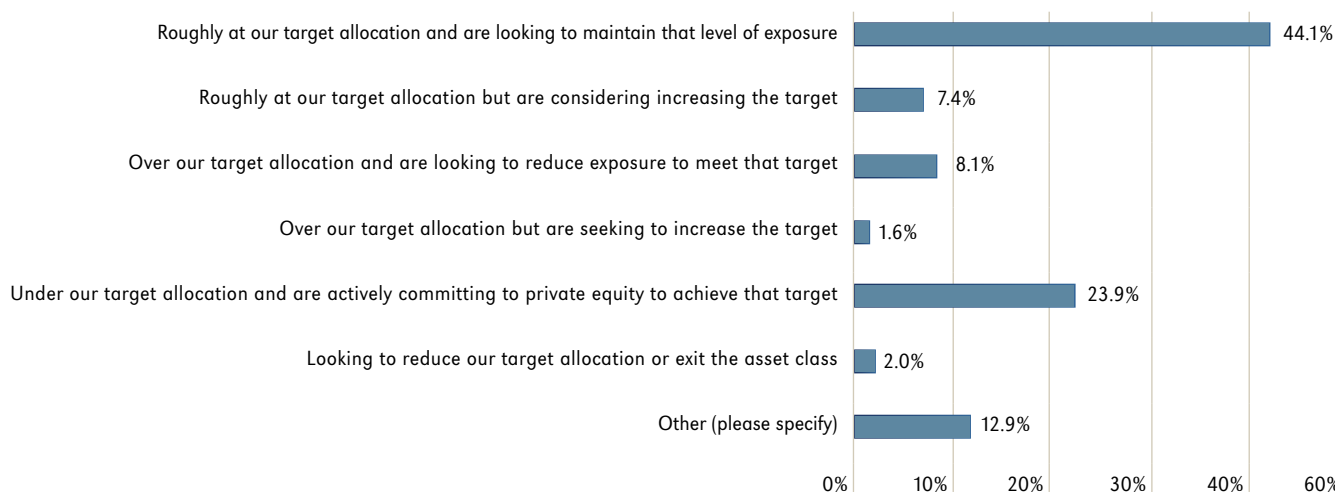
I. Are LPs Over Their Alternative Investments Allocation?

As illustrated in Chart I, 61% of respondents are either at or over their target allocation, while only 24% are under their target allocation to alternative assets and are actively committing to achieve that target. Somewhat surprising, however, is that only 10% of those that are at or over their target are looking to reduce exposure, while the others are seeking either to maintain exposure or increase their allocations.

Thirteen percent of respondents reported “other” responses to the question of target allocation. These respondents listed such responses as “no target allocation,” and “under target but capital constrained.”

We believe liquidity issues for those not looking to reduce exposure today are likely to become more acute when new investment activity begins to increase. Exits and distributions are likely to trail capital calls significantly. Unless there continues to be an increase in values in other asset classes, this will likely put greater selling pressure on investors who are already at their target allocation.

Chart I “As Far As Our Current Private Equity, Real Estate, Infrastructure, or Other Alternative Asset Allocation, We Are...”



Source: Probitas Partners

II. Are More People Buying Secondaries Today?

As Chart II illustrates, there is significant interest in purchasing secondary positions in the current environment, with 59% of respondents believing that attractive positions will be available at steep discounts. Institutions that traditionally have not been active buyers in the secondary market, or have used secondary fund-of-funds to gain access to secondaries, have said they expect to be much more active buyers going forward, acting both opportunistically and strategically. Only 16% of respondents stated that they have no interest in purchasing secondaries at this point.

In our experience most of these new entrants are focusing strategically — on smaller or one-off transactions in specific funds that they know well or on funds they have targeted to gain access — as well

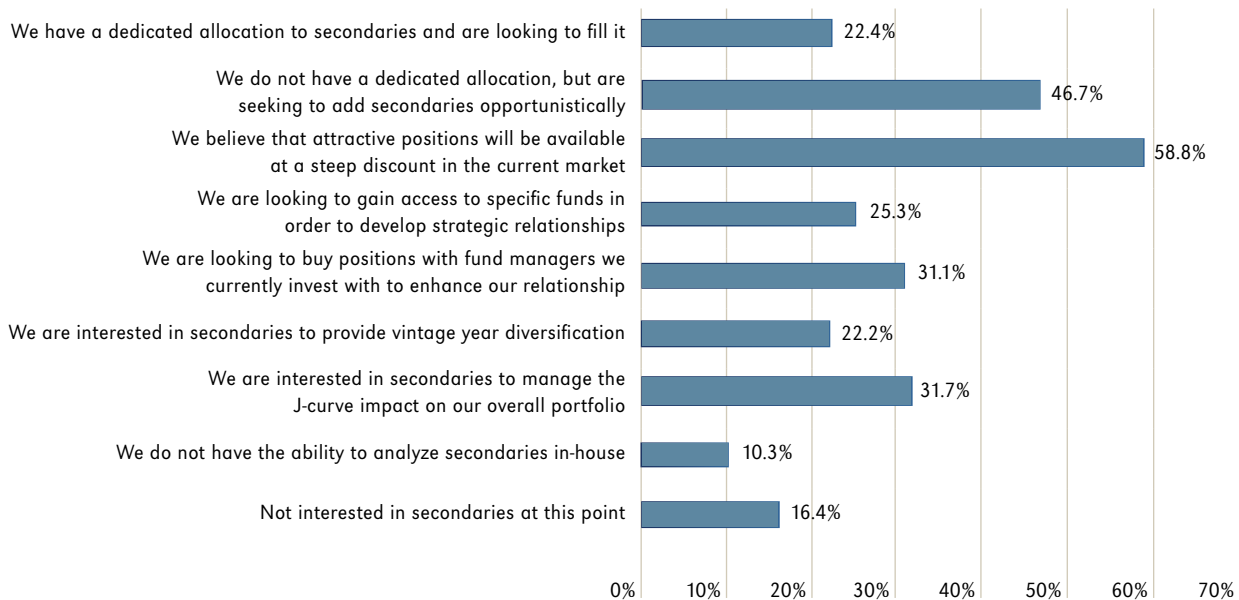
as on economic returns. We believe this is a long-term trend and that non-specialist buyers will continue to purchase secondary interests to strategically round out their portfolios.

III. What Secondary Assets Do People Want to Buy?

The next section of the survey, with responses illustrated in Chart III, asked what fund types investors would be willing to buy.

Not surprisingly, respondents found middle market/large buyout funds and the small buyout and growth capital categories of most interest, with 74% of willing buyers interested in middle market/large buyout funds, and 82% interested in small buyout and growth capital funds. These positive feelings did not extend to mega buyouts, however, with 56% of

Chart II “For Those Respondents Who Are Looking to Purchase Secondary Positions (Please Check All That Apply)”



Source: Probitas Partners

Note: As respondents were able to select more than one option, the chart does not add up to 100%.

willing buyers expressing no interest in the sector. Besides these sectors, only two others attracted buying interest from more than 50% of respondents: distressed debt at 59% due, we believe, to a perceived plethora of attractive opportunities in this market; and venture capital at 58%. Secondary demand for venture capital, particularly for the top-tier names, has not fallen as dramatically as it has for buyout in recent years.

The fund types of least interest to potential buyers included:

- **Fund-of-funds:** 72% indicated no interest in the sector, presumably because these funds are difficult to analyze and do not satisfy investors' desire for specific managers;
- **Infrastructure funds:** 68% indicated no interest, we expect because the sector is very new with little seasoned product available; and
- **Other Real Estate:** 68% expressed no interest in these funds (composed of core and value-added strategies as opposed to opportunistic real estate), likely due to lower return targets, shallowness of the market, and increasing difficulties in the commercial sector.

Lastly, there was a strong desire among willing buyers — both specialists and non-specialists — to purchase positions in specific funds rather than general portfolios, with 66% of willing buyers not interested in the latter. As a leading secondary advisor, we see daily evidence of this. Larger portfolios today are more successfully sold by breaking them up into strategically targeted component parts. This allows buyers to take more active sector bets, strategically look to establish/build relationships with a single fund manager, and/or invest in funds with which they have experience and about which they have detailed knowledge.

IV. What Are Buyers Willing to Pay?

Clearly, the driving factor in secondary volume today is pricing. The survey generally confirmed Probitas Partners' experience thus far in 2009. Seventy-five percent of willing secondary buyers indicated that a discount to most recent NAV of at least 40% was required.

Not surprisingly, price indications were most aggressive for mega buyout funds, where 52% of respondents who indicated an interest in this fund type were looking for a discount in the range of 60% to 80% off of most recent NAV. We expect this view is due in part to the perceived high risk in these funds, resulting from a combination of high purchase multiples and leverage levels and depressed earnings.

While buyers favor middle market/large buyout funds and the small buyout and growth capital categories as outlined above, 50% and 56%, respectively, of respondents willing to buy those two fund categories indicated that discounts of 40%-60% off most recent NAV are required. In our conversations with potential buyers, there are of course significant pricing differentials, and in some cases outliers, based upon the quality of the underlying portfolio companies and the reputation of the manager.

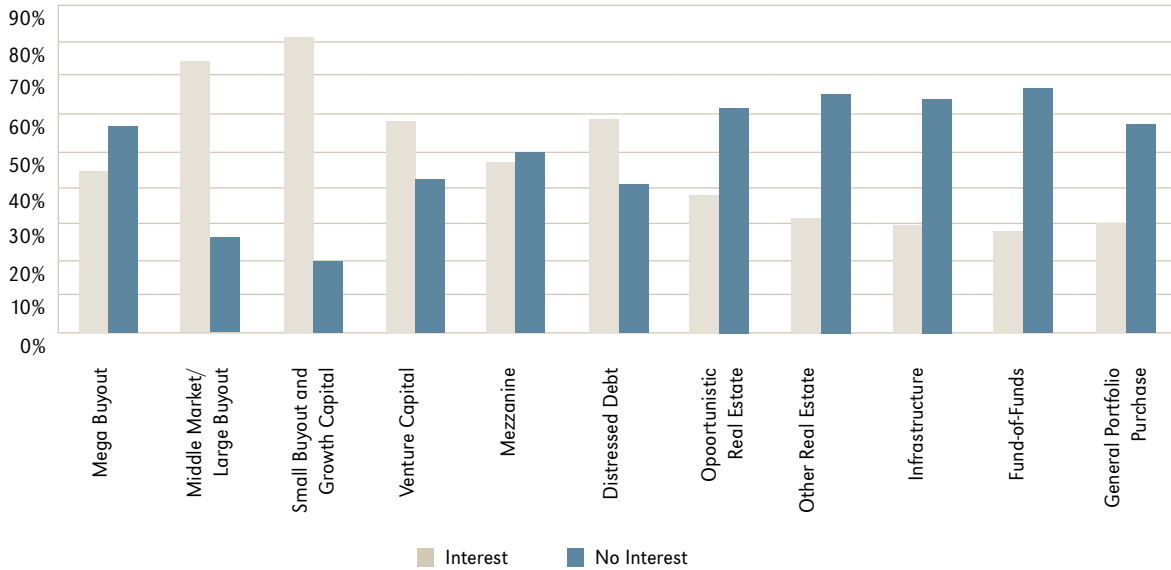
V. What Are People Looking to Sell?

Another element of our survey was to explore who is interested in selling positions in the secondary market and what they are looking to sell. We asked about preferences regarding fund type, price and geographic location of the fund, for respondents who would be willing sellers.

A high percentage of respondents, 72%-88% depending on fund type, indicated no interest in selling at all. This result might be surprising given some of the recent media coverage of the secondary market and the available supply of opportunities being discussed. We believe the responses are pricing related, and that more investors would consider selling fund interests in a better pricing environment.

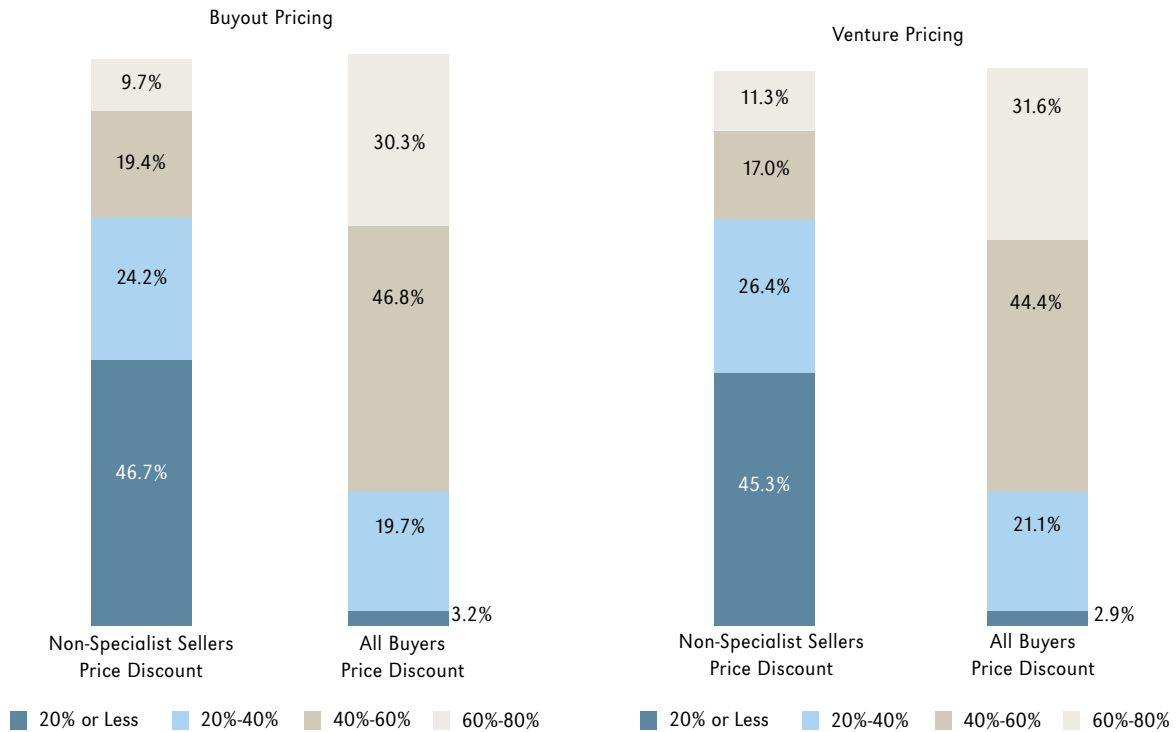
Probitas Partners' discussions with investors during recent months have shown that investors that are declared sellers are balking at discounts in excess of 30% for mature funds. The survey confirmed that market reality. Between 63% and 73% of willing sellers, depending on fund type, would only be willing to transact at discounts less than 40%. This fact, together with the previously stated 75% of willing buyers are only interested in buying interests at discounts of at least 40%, highlights the current bid/ask spread that is impacting the secondary market.

Chart III Interest Level of Willing Buyers Depending on Fund Type



Source: Probitas Partners

Chart IV Secondary Buyout and Venture Pricing All Buyers vs. Non-Specialist Sellers Discount



Source: Probitas Partners

VI. What Characterizes the Alternative Assets That Have Been Sold in the Secondary Market in the Last Twelve Months?

We asked respondents who had sold alternative assets during the past twelve months to indicate the size of the transactions executed. Eleven percent of respondents stated that they had sold assets in the secondary market in the last twelve months. Thirty-six percent of those transactions were individual interests, 21% were portfolios of less than \$50 million, 14% were portfolios between \$50 million and \$100 million, and eight respondents, representing 19%, had sold portfolios valued in excess of \$100 million. Ten percent of respondents tried to sell assets but were unable to close.

We did not ask the respondents who had sold portfolios to elaborate on the number or the type of buyers who were involved in the transaction. However, in our experience, most transactions in the current market involve multiple buyers, who each buy individual funds, or a family of funds of the same manager. This is a significant departure from the market environment two years ago, when many buyers were favoring large portfolio transactions. We expect this “one seller – multiple buyer” market environment to continue for the foreseeable future, which makes execution more complex although it may maximize price.

VII. How Do Investors Characterize the Current Secondary Market?

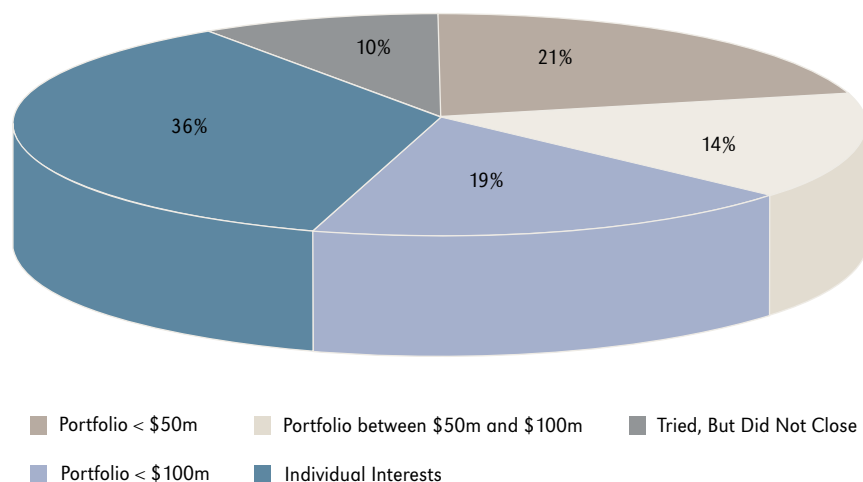
Lastly, we wanted to gauge how alternative asset investors view the current secondary market, and asked respondents to choose the two characteristics

that they felt most strongly represented market conditions. As Table I indicates, 59% of respondents believe that sellers have price expectations that are too high, and 39% of respondents believe that assets are over-valued by the general partners. These responses are reflected in the wide bid/ask spreads that persist in the market.

We believe the key to future activity in secondaries lies in the third most popular answer listed in the table: over a third of respondents felt that the economy needed to stabilize before transaction volumes would increase. As long as the global recession remains and liquidity in the capital markets is uncertain, so too will be liquidity expectations for underlying portfolio investments. Moreover, there continues to be limited transparency in the future operating performance of those portfolio companies. As a result of both of these factors, buyers are pricing in a level of uncertainty and risk, which as we have discussed previously, creates a pricing environment perceived as less interesting for willing sellers.

We believe that alternative asset secondary buyers will gain confidence and become more aggressive in pricing as a percent of stated NAV as the economy stabilizes; volatility in the equity markets declines; there is greater transparency into portfolio company performance; and general partners continue to write down portfolio NAVs more accurately to reflect current conditions. As a result, discounts to reported NAVs are likely to shrink, and secondary transaction volume is likely to increase. In the interim, the bulk of activity in the market will be driven by sellers who need current liquidity, even in the face of steep discounts, and by sellers who wish to proactively manage against potential liquidity issues by selling highly unfunded positions.

Chart V Secondary Transactions During the Past Twelve Months



Source: Probitas Partners

Table I “I Would Characterize the Current Secondary Market As (Check the Two You Feel Most Strongly About)”

Answer Options	Response Frequency
Sellers have price expectations that are too high	58.5%
Assets are over-valued by the general partners	39.2%
Economy must stabilize before transaction volume can improve	34.5%
More primary investors are looking to buy secondaries than ever before	32.4%
Buyers have price expectations that are too low	25.6%
Investors are avoiding forced sales by increasing permitted allocations for alternative assets	12.3%

Source: Probitas Partners

CONCLUSIONS

Putting the survey in the context of the activity we see daily in the market, we have come to the following conclusions:

- We believe that activity in the secondary market will gradually increase in the second half of 2009 as markets begin to stabilize. Continued write-downs of fund NAVs and firming in pricing will result in narrowing bid/ask spreads, which in turn will make asset sales more attractive for sellers who are not only seeking liquidity but are looking to rebalance portfolio exposures. Buyers will continue to be highly selective.
- This environment feels like the 2001-2003 period, after the Internet Bubble burst, when secondary market activity decreased significantly for four to five quarters. As transparency and the macro environment improved, buyers started to regain confidence, bid prices improved and transaction volume gradually increased.
- Highly unfunded positions, especially in mega buyout funds, will continue to attract limited buyer interest. Structured solutions are likely to continue being pursued to relieve sellers of unfunded commitments, with preferential returns going to the buyer who commits to meet the unfunded capital calls.
- As began in the latter half of 2008, matrixed sales targeting individual buyer demand for specific funds are likely to predominate instead of bulk portfolio sales, continuing to make the sales process complex. Large bulk portfolio sales to single buyers will continue to be difficult to execute. Price maximization will be achieved by finding the buyer who is seeking targeted fund interests, and/or has the better knowledge of and comfort with the asset.

San Francisco
425 California Street
Suite 2300
San Francisco, CA 94104
USA
Tel: +1 415 402 0700

New York
1251 Ave. of the Americas
Suite 2390
New York, NY 10020
USA
Tel: +1 212 403 3662

London
1st Floor Dudley House
36-38 Southampton Street
Covent Garden
London WC2E 7HF
Tel: +44 (0) 20 7845 5400

Hong Kong
21/F ICBC Tower
Citibank Plaza
3 Garden Road Central
Hong Kong, China
Tel: +852 2273 5143

Confidential and Trade Secret.

2009© Probitas Partners. Do not circulate or publish.

secondary@probitaspartners.com

All rights reserved. Photocopy and reproduction permission is available from Probitas Partners by writing to David Dinerman in the San Francisco office at dqd@probitaspartners.com. Any reproduction of this newsletter without Probitas Partners' prior consent is an infringement of copyright law.