

## Secondary Market Barometer

### Look Back (Q1 2010)

Transaction Volume ▼  
Pricing ▲  
Bid/Ask Spread ▼

### Look Forward (Q2 2010–Q3 2010)

Transaction Volume ▲  
Pricing ▲  
Bid/Ask Spread ▼

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## Introduction

Spinouts, or the creation of a new firm from an existing investment team at a sponsor institution, have become an increasingly common theme. Often, these spinouts can present attractive opportunities for secondary investors. For the newly formed team, spinouts allow General Partners (“GPs”) to efficiently raise and invest new capital and develop their fully independent track record. For investors in the new enterprise, spinouts provide J-Curve mitigation and improve risk/return management.

In this *Second Thoughts* newsletter, we review the often complex avenues that have been pursued to achieve independence and the considerations for investors when reviewing a spinout opportunity.

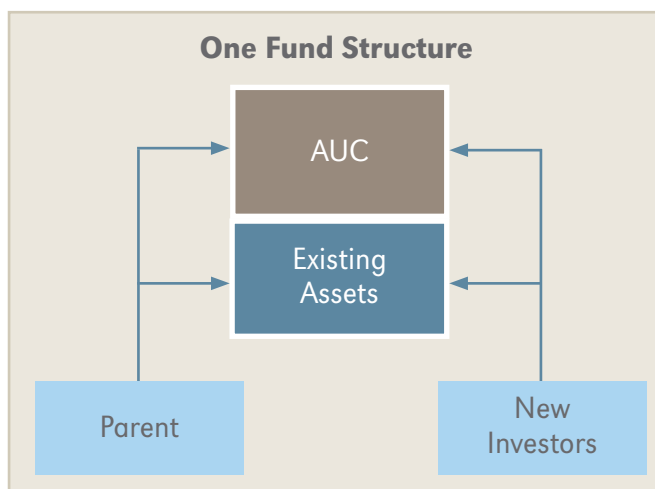
## Structural Options

Spinouts undertake a wide variety of often complex structures. We will focus on two traditional processes: the “one fund structure” and the “stapled secondary.”

### One Fund Structure

In the one fund structure, new investors and the prior sponsoring entity (the “Parent”) commit to a new fund. The Parent agrees to sell existing assets into the new vehicle at a specified price. The Parent will then have the option to roll a percentage of its proceeds as a new commitment into the new vehicle (associated unfunded commitment or “AUC”). All investors, including the Parent and new investors, will own a pro rata share of the existing assets and of future investments.

The underwriting return or expected Multiple of Invested Capital (“MOIC”) of new capital is a key determinant of the new fund size. Generally, the size of the fund will be determined by the “staple ratio,” or the proportion of revalued existing assets to the AUC. As such, the smaller the expected MOIC, the lesser the proportion of new capital raised for the fund and/or the lower the price offered for the existing assets. The one fund structure is illustrated below:



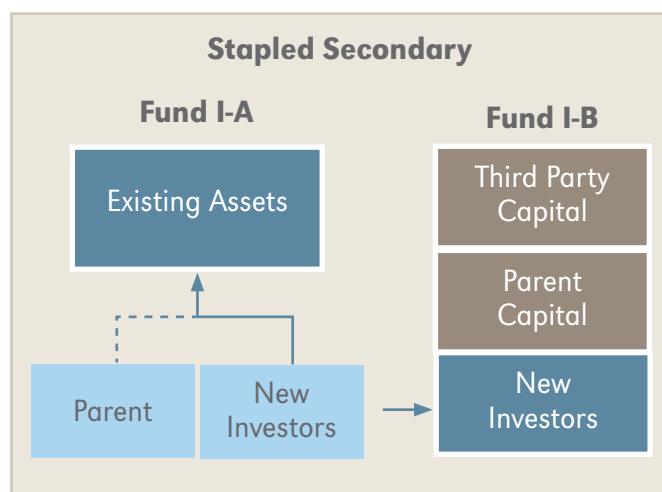
The pros and cons of the one fund structure are summarized below:

PROS	CONS
<ul style="list-style-type: none"> <li>A Parent seeking to build longer term enterprise value can leverage the newly formed fund to create a platform from which to market future vintage funds.</li> <li>Investors can offer structural payment alternatives such as delayed payment options to improve purchase price and/or fund size.</li> <li>Depending on the quality of the assets, the Parent has the potential to create a larger fund size relative to other alternatives.</li> </ul>	<ul style="list-style-type: none"> <li>The Parent’s sensitivity to discount to Net Asset Value (“NAV”) on the underlying contributed assets naturally caps the size of the single fund structure due to the staple ratio.</li> <li>New investors will be sensitive to Parent’s investment amount – a large commitment may signal too much influence, whereas a small commitment may reflect lack of confidence.</li> </ul>

### Stapled Secondary

In a stapled secondary, the Parent agrees to sell up to 100% of the existing assets to new investors at a specified price. As part of the sale, new investors agree to commit capital to a new fund as part of the acquisition of existing assets. This commitment

is known as a “stapled commitment.” The Parent, if it holds any share of the existing assets, may also make a commitment to the new fund. The new fund typically raises independent commitments from other third party investors.



The pros and cons of the stapled secondary are summarized below:

PROS	CONS
<ul style="list-style-type: none"> <li>The Parent can manage ownership levels in the existing assets and new fund; thus, the fund size is not limited by the staple ratio.</li> <li>The Parent can offer structural alternatives such as delayed payments to increase potential purchase price and/or staple ratio.</li> <li>Independent investors may commit solely to the new vehicle, increasing the fund’s size and potentially targeting a different group of investors.</li> <li>There is no need to transfer existing assets into a new vehicle.</li> </ul>	<ul style="list-style-type: none"> <li>Separate vehicles reduce the size of each fund, which may limit the size of the next fundraise.</li> <li>With assets segregated from new capital, investors have greater ability to try and limit their new fund participation.</li> </ul>

## Spinout Considerations

Spinning out from a corporate Parent offers several advantages to the investment team. Importantly, separating from the Parent allows the manager not only to fully leverage its brand and build a track record independent from the Parent, but also provides the General Partner (“GP”) with the ability to implement a compensation structure to attract and retain staff and construct a diversified and durable capital base.

Furthermore, both structural options of spinouts hold many of the same advantages that apply to traditional stapled secondary transactions. Primarily, a stapled secondary allows the GP to invest new capital via a new fund, even if the existing assets are predominately unrealized. Additional capital is especially important during economic downturns which, while often the worst times to realize investments, are often the best times to make new investments. In addition, raising a new fund can be a time-consuming process, which may result in little or no money raised, especially if the track record is too young or weak. The amount of time required to execute a stapled transaction can be significantly shorter than that of a traditional primary fundraise.

A spinout can be attractive for investors by virtue of the following:

**Mitigation of J-Curve for new investors** — Like a traditional secondary transaction, acquiring existing assets can mitigate the J-curve for buyers. Since these assets are generally more mature, they are closer to liquidity and allow investors to avoid early management fees.

**Reduced blind pool risk** — To the extent that the GP is spinning out with an existing unrealized portfolio, investors will have the opportunity to underwrite an existing pool of assets, as opposed to a blind pool. Often, diligence in spinouts is easier for investors than traditional secondary sales. Since the GP is typically motivated to consummate a transaction, ample information is available to potential investors. Although a staple investment to unfunded capital still applies as part of the transaction, both manager and strategy risk are reduced.

**More diversified set of LPs** — Because spinouts typically consist of transferring or selling existing assets into a newly formed fund, these processes

will attract both primary investors looking to make commitments to new funds, as well as secondary investors seeking to acquire existing assets. Many of these secondary investors also make primary commitments, making them potential long-term relationships. In addition, many LPs, who do not invest in sponsored funds, may now consider the newly independent manager.

Conversely, spinouts also hold their share of both structural and strategic considerations, which should not be taken lightly by the GP. These considerations include the following:

**Some investors will want to purchase assets at a discount** — Like a traditional secondary, investors will underwrite both the existing assets and the AUC to a desired return in order to formulate pricing. A discount may therefore be applied to the NAV of the existing assets to generate the desired return. In some cases, the Parent may not want to sell assets at a discount. In these situations, structured alternatives such as delayed payments or earnouts may help improve purchase price.

**Lead investors will negotiate ratio of assets to the AUC** — Many investors are constrained in the amount of capital they are able to contribute to the AUC in relation to the secondary transaction. Lead investors will likely negotiate to minimize the size of the AUC, thus constraining the GP’s ability to make new investments.

**Interests of Parent and GP may not be aligned** — The Parent may be interested in maximizing proceeds for the sale of the existing assets. Due to the staple ratio, higher pricing on the existing assets may result in less AUC for the GP to invest on a go-forward basis. As a result, internal conflict may exist between the Parent and the GP.

**Reputation and quality of General Partner matters** — LPs will not support a manager with a poor track record or reputation regardless of the price. Although investors will underwrite to acquire an existing pool of assets in these spinout transactions, they will also commit new capital to the manager on a blind basis. Even at a significant discount on the existing assets, the buyer may deem the new fund too risky for investment.

**Exposes the manager to more primary diligence** — Spinouts often require investors to conduct primary due diligence on the GP. As a result, certain confidential information, including track record, attribution, turnover, etc., may have to be shared with potential investors.

**Favor LPs with long-term relationship goals** — While accepting pure secondary investors may provide liquidity to the GP's underlying LPs and provide capital for future investments, the GP should favor investors with the capability to make future primary investments. Developing a long-term relationship will help the GP secure future fund commitments and promote growth.

## Conclusion

We expect spinouts to become a more frequently pursued path for captive funds to generate liquidity and achieve independence. Although often complex and with a number of considerations, spinouts allow the Parent to maximize value for its existing assets, provide liquidity to the GP's underlying LPs, and allow the General Partner to continue to invest and generate a track record independent from its corporate Parent. In our dialogue with LPs, we have witnessed increased interest in these types of transactions as potential investors continue to seek ways to mitigate the J-Curve and perform better risk/return management. As these LPs begin to realize the benefits, we believe that investing in spinouts may become nearly as pursued as traditional secondary transactions.

Probitas Partners is a market leader in advising on secondary transactions, including spinouts, stapled secondaries and other complex structured transactions. With its dedicated secondary team, extensive experience and global distribution, Probitas Partners is able to position opportunities for the best marketability to ensure maximum proceeds and an efficient transaction.

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