

Secondary Market Barometer

Look Back (Q3 2009)

Transaction Volume ▲
Pricing ▲
Bid/Ask Spread ▼

Look Forward (Q4 2009-Q1 2010)

Transaction Volume ▲
Pricing ▲
Bid/Ask Spread ▼

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Annex Funds and Strips

Introduction

The current economic recession has caused realizations of companies backed by private equity and venture capital managers to slow dramatically. As a result, an increasing number of fund managers have found their capital reserves for follow-on investments to be inadequate. In response, several fund managers have attempted to organize Annex Funds.

Annex Funds came to prominence in the wake of the Internet Bubble bursting. Venture managers such as Accel, Benchmark Capital, Mayfield and NEA (along with a number of less well-known managers) raised Annex Funds then, predominantly with backing from existing investors, and mostly with more LP favorable terms than those of their Main Funds. While limited performance data are available, the post-Internet Bubble Annex Funds with published performance data did not generate strong returns for their investors.

The Current Downturn and Annex Funds

Today's economic and credit cycle has created liquidity issues that are hitting buyout managers more heavily, though the collapse of the IPO market has affected certain venture managers as well. Annex Funds have been raised or are in the market by such high-profile firms as KKR, Sun Capital and MatlinPatterson, as well as venture managers such as Kleiner Perkins and Mohr Davidow and well-known European managers such as Investindustrial of Italy.

Over-levered companies requiring financial restructuring and venture capital companies facing elongated periods of cash burn need additional capital to protect existing investments or to survive longer. Their first stop is with existing investors. These investors are often forced to decide between dilution of their existing position or providing additional financing.

Complicating the situation, a large number of institutional investors face allocation or liquidity constraints. As a result, in many cases, they are unable to support an Annex Fund even if they want to. Further, given many investors' concern that Annex Funds throw good money after bad, raising an Annex Fund is proving challenging. For those fund managers able to raise Annex Funds, most include a diluted fee and carry structure compared with the previous primary fund, and all but the most successful managers have needed to include a preferred return to investors supported by a priority claim on the returns of the Main Fund the Annex Fund is designed to support.

As many limited partners are capital constrained, secondary specialists have often become the go-to capital source for managers seeking to hit targets on Annex Funds. Secondary specialists have the requisite expertise and resources to value underlying companies in the Main Fund that serve as the source of support for the preferred return on the Annex Fund. In what has been a slow secondary

market, these funds present an attractive alternative for deploying capital for secondary specialists. Secondary funds are attracted to the downside protection afforded by the Main Fund assets, the preferred return and the ability to invest in known companies that they can evaluate at a preferred level.

Preferred return structures can vary greatly, but often have both multiple and IRR hurdles. A number of recent transactions have contained preferred multiples in the 1.8x to 2.0x range, often coupled with an IRR hurdle of 20% to 25%, with the Main Fund's assets serving as a backstop. This structure, of course, results in an effective "cramdown" of investors in the Main Fund, and can be especially painful for those investors who cannot participate on at least a pro rata basis in the Annex Fund. As one current investor put it, "it is like putting a gun to my head" when the commitment decision is being made on the Annex Fund. On the other hand, existing limited partners may be better off in the long run if their "out of money" managers find a way to raise the capital they need to support companies that still have good prospects. At the end of the day, the general partner has an obligation to do what is best for the existing limited partners, and if protecting the equity invested is the right decision, the Annex Fund may be the least painful route that retains the greatest control while achieving the intended economic protection of the underlying asset.

For any institutional investor, including a secondary specialist, who is considering investing in an Annex Fund, there are a number of issues to consider besides the preferred return:

- **What are the incentives of the fund manager?** If the Annex Fund does not produce decent returns, it will be very difficult for the general partner to raise a subsequent fund. As such, if the legacy portfolio is in dire straights, the manager might take risks that they otherwise would not take, effectively leaving investors with the bill on aggressive decisions gone wrong with "good money gone after bad."
- **Who are the syndicate members or "club" participants in key target portfolio companies?** Especially in venture capital, if the syndicates alongside companies in which a fund manager invested are weak and lack the ability to support portfolio companies, a small amount of added capital from a single Annex Fund may be irrelevant. Further, collective support from other quality investors validates the decision to invest additional capital and should offer some element of de-risking for the Annex Fund investors.
- **What are the assets backing the Annex Fund?** The quality of the remaining holdings of the primary fund and the ratio of the primary fund to Annex Fund capital determine the level of support backing the preference, and must be understood.

Under most Limited Partnership Agreements, the manager will need to obtain approval from the Main Fund investors before launching an Annex Fund. An analysis showing why a preferred return Annex Fund is both needed and to the advantage of the Main Fund investors will be critical to secure their votes.

That analysis is complex and heavily dependent on both the specific structure being proposed as well as assumptions used in the valuation model. A simple example is set out in Table I showing comparative multiples between the Main Fund and the Annex Fund under a given set of assumptions.

Actual returns to Annex Fund and Main Fund investors can vary tremendously even from this simple example based upon a number of key factors:

- **Use of an IRR preference in addition to multiple:** Adding an IRR preference in addition to a multiple adjusts for the time value of money, providing an additional benefit to Annex Fund investors if cash returns are drawn out to the additional detriment of Main Fund investors.

Table I

	Total Size, Main Fund		100					
	Total Size, Annex Fund		25					
	NAV of Main Fund at Close of Annex Fund		80					
	Coverage Ratio, Main Fund Value to Annex Fund		3.20x					
	Annex Fund Preference Multiple		1.75x					
Gross Return, Combined Vehicles, \$ million	\$43.8	\$87.5	\$125.0	\$143.8	\$150.0	\$162.5	\$175.0	\$187.5
Assumed Multiple, Combined Vehicles	0.35x	0.70x	1.00x	1.15x	1.20x	1.30x	1.40x	1.50x
Multiple as Allocated to Annex Fund	1.75x	1.75x	1.75x	1.75x	1.80x	1.90x	2.00x	2.10x
Multiple as Allocated to Main Fund*	0.00x	0.44x	0.81x	1.00x	1.05x	1.15x	1.25x	1.35x

* Assumes sharing pro-rata based on committed capital after Annex Fund preference is met.

- Comparative quality of the Annex Fund and the Main Fund:** For simplicity's sake, the example looks at the performance of the Annex Fund and the Main Fund based on the performance of the pool of assets in both vehicles. In reality, the Annex Fund will invest in a subset of the assets in the Main Fund – those transactions needing additional capital that are deemed to have strong prospects at the point of new capital injection, with investments made in later rounds than the Main Fund – and will naturally have a different risk/return profile than the Main Fund. No matter what returns the Main Fund generates, a strong performance by the Annex Fund investments means that the preference returns could be generated without disadvantaging the Main Fund.
- Asset coverage quality and ratio:** The example we have used sets out an asset coverage ratio based upon the NAV of the Main Fund at the time the Annex Fund closes. On a simplistic basis, the higher the coverage ratio – the higher the amount of assets protecting the Annex Fund preference – the more secure the Annex Fund return should be. The major underlying assumption here is that the NAV is correctly or conservatively valued. A poor

quality portfolio likely to engender further writedowns puts the preference coverage at risk.

In this simplified scenario, a primary fund investor breaks even on its investment when the combined vehicles achieve a 1.15x multiple. In fact, the 1.75x multiple offered to the Annex Fund investors is protected even if the funds on a combined basis only generate a 0.35x. The preference structure and coverage ratio provide strong returns to the Annex Fund, at least in terms of multiple, even in a challenging return environment.

Possible Alternatives and Strip Sales

A fund manager seeking capital to protect its fund investments must ask: "Where can I find the capital I need to support my portfolio, and how can I raise this at the lowest cost to least dilute my limited partners?" Depending upon the terms of the Limited Partnership Agreement and the willingness of current investors, a fund manager might have other options available: the ability to recycle distributions, diverting management fees into investments, or re-opening the fund to new investors. Some banks have also started to offer loans to fund managers with the portfolio

investments serving as backstop. In most of these cases, however, either the amount that can be raised is insufficient, or difficult issues of priority and preference arise similar to those involved with Annex Funds.

Due to these issues, some managers have elected to sell a percentage of a subset of the primary fund portfolio through so-called Strip Sales. Given that buyout deals are normally much larger and have the added complexity of being leveraged, Strip Sales have been limited to venture backed companies to date.

Buyers of these Strips are most often secondary direct specialists, who cherry-pick a handful of companies, and buy, for example, 10% to 25% of the fund's investment in individual companies. By selecting positions in specific companies they find most attractive, the buyer of the Strip acquires a portfolio that it feels will perform well at a price that provides an attractive return at a risk level that they tailor. On the other hand, the fund manager generates additional cash that, under most fund structures, can be redeployed to support follow-on rounds for its most promising companies while avoiding being crammed down themselves in these fundraisings.

This approach has its pros and cons compared with Annex Funds. For the fund manager, the process can proceed quickly as there is usually no need to get limited partner approval. The Strip Sale process itself, however, is usually highly negotiated, as positions targeted and percentage purchased can fluctuate. These negotiations and the need for confidentiality usually result in an inherently limited competitive process, but a targeted, well orchestrated competitive process can result in more favorable pricing to the fund.

The most significant advantage for the manager is that, in most circumstances, a Strip Sale is much less dilutive than a preferred return Annex Fund. The process results in giving up some of the upside in some of the fund's most attractive investments but without being subject to a cramdown on the value of the whole fund.

Summary

As the traditional secondary market strengthens in the final quarter of 2009 and into 2010, preferred return Annex Funds and Strip Sales are likely to become less of a focus for secondary specialists. Notwithstanding that trend, these structures are likely to be a durable solution to financing problems in the future, and Secondary Strips in particular are likely to be a positive alternative to Annex Funds for both managers and LPs, as well as a continuing opportunity for direct secondary players.

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