**Successful secondaries**

Lars Lindqvist of Cattegatt Capital details the key considerations for buyers and sellers during secondaries transactions.

**At a glance**

* Because the price of secondaries are negotiated, valuation of the interests plays a primary role in the sale
* Perhaps counterintuitively, sellers have relaised there is no time like the present to obtain attractive pricing for their assets
* Arguably the only "real" valuation is the size of the bid on the secondary market

Valuation of assets in the secondaries market is a topic which has taken centre stage of late. With new capital requirements and legislation – Solvency II, Basel III and the Volcker Rule – there is a need for institutions affected by these measures to sell off non-core and speculative assets in order to comply. Because there is no public market for these assets, there are no public buyers or public prices for these assets either, and so these institutions turn to the secondaries market.

In a secondary transaction, an existing investor in a private equity fund would ask a broker to find a buyer for the interest it holds in that fund. The third-party buyer will then negotiate a sale price and, with the permission of the fund manager, take control of the interest and any obligations associated with it, such as unfunded commitments. Because the price is negotiated, sometimes anonymously through the broker, valuation of the interests being sold naturally plays a primary role in the sale – discounts to NAV can be offered for assets and attractive opportunities can be found by buyers.

**Valuation**

Valuation of these interests can be a sensitive issue among buyers, who are looking for a good return; sellers, who don’t want to realise losses when selling; and fund managers, who don’t want to see interests in their fund trading below its net asset value. Part of the broker’s place in this mix is to manage expectations and ensure each party is happy with the deal brokered and ultimately finalised.

The key considerations for valuations are the amount and likelihood for distributions – cash flows from exits or wind down – which in essence is what a buyer pays for. Since most of the value creation may have already crystallised, buyers are not generally willing to pay extra for further potential NAV growth. For example, if you buy a fund which was set up in 2001, a lot of the value would already have been realised and in such cases the debate is, of course, how large the discount should be.

For those funds which are invested in physical assets there is less discrepancy, although with hedge fund strategies it can be less clear. One reason for this lack of clarity could be that the exit opportunities are uncertain; another is how accurately valued the underlying assets in which the fund manager invested in are.

**Pressures on pricing**

There are several other immediate upward and downward pressures on the pricing of interests: in an atmosphere where selling is necessitated by legal obligation, pricing is a concern to sell-side institutions that are aware valuation works in no small part on the basis of supply and demand. At first glance, it certainly seems prudent to wait for there to be fewer assets available before selling; it has been suggested by some that $2.3trn (€1.75trn) worth of non-core assets could potentially comprise the secondaries market universe. As it happens, European banks sit on a large part of this – particularly German and UK banks, with half a trillion each.

Most institutions are not generally concerned with oversupply and sellers have realised that there is no time like the present to obtain attractive pricing for their assets. Though available supply has increased, the counterbalance is that there is also big demand from secondaries funds. In fact, there have recently been some major transactions with private equity secondaries in particular, and there is a significant amount of unspent money about which must either be invested in secondaries or returned to investors.

Nevertheless, there are funds which still trade at large – even 100 per cent – discounts, such as interests in funds being investigated by the SEC, while conversely, interests in ongoing private equity or hedge funds which may be closed to new investors, due to a cap on capital, may trade in the secondaries market at a premium.

Institutions are aware that if they hold particularly esoteric assets – like a hedge fund investment in a private equity fund’s side pocket – they will have to offer a deeper discount to NAV in order to secure a buyer. Holdings in junior mining projects, emerging market real estate and distressed funds in Eastern Europe have all also recently sold for discounts of between 50 and 70 per cent.

**The “real” valuation**

Another increasingly debated valuation aspect during 2011 was whether to base valuation on the NAV as reported by the fund manager, which may be stale, or to base it on the last traded bid in the secondary market. Since the latter tends to be lower than the former, this may not be the preferred method, but the fact is that this is the value sellers would get if they were to offload the assets in the secondary market, which is why it deserves attention for risk management purposes. One could argue that the only “real” valuation is what the bid is on the secondary market: what good is it to have a value of x if no investor is willing to pay that?

For buyers, the best advice is to become well informed about what they are buying. Read up well, then aim to cover up for any extra uncertainty which you know may exist there.  
  
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