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Mid-Year 2008 Secondary Market Pricing and Outlook

Secondary Pricing Declines with Public Market Drop

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Executive Summary

The deterioration of the credit markets and resulting economic slowdown has resulted in a general malaise in private equity. As investors seek to manage and shift their private equity exposure, interest in secondary market pricing levels has heightened. As the secondary pricing received for Cogent-represented transactions remained very strong through the end of 2007, even as the credit markets froze and large private equity transactions were abandoned, a review of the market's impact on pricing for the first half of 2008 seems appropriate.

As detailed in Cogent's Secondary Market Pricing and Outlook, 2007, the average winning bid for limited partnership interests remained around net asset value, even during the second half of 2007, when the change in market conditions was apparent. This updated analysis indicates that, as the market shift solidified in the first half of 2008 and public equity values fell, the price received for private equity interests declined to a similar degree. Specifically, this update finds:

1. The average high bid for all secondaries, stated as a percentage of net asset value, fell precipitously in the first half of 2008 to 84.7%.

2. The fall in secondary sale value largely mirrors the decline in public equity value, when adjusted for leverage.

3. The decline in pricing is partially the result of deteriorating prospects for fund portfolios as communicated by fund sponsors.

4. Secondary buyers have increased secondary underwriting rates, though the rates still remain below most investors' expected returns for the asset class.

5. A portion of the decline in pricing may be driven by product mix, with more liquidity-motivated sellers who are less concerned with crafting a portfolio to achieve pricing at or above net asset value.

Data Sample for 1H2008 Analysis

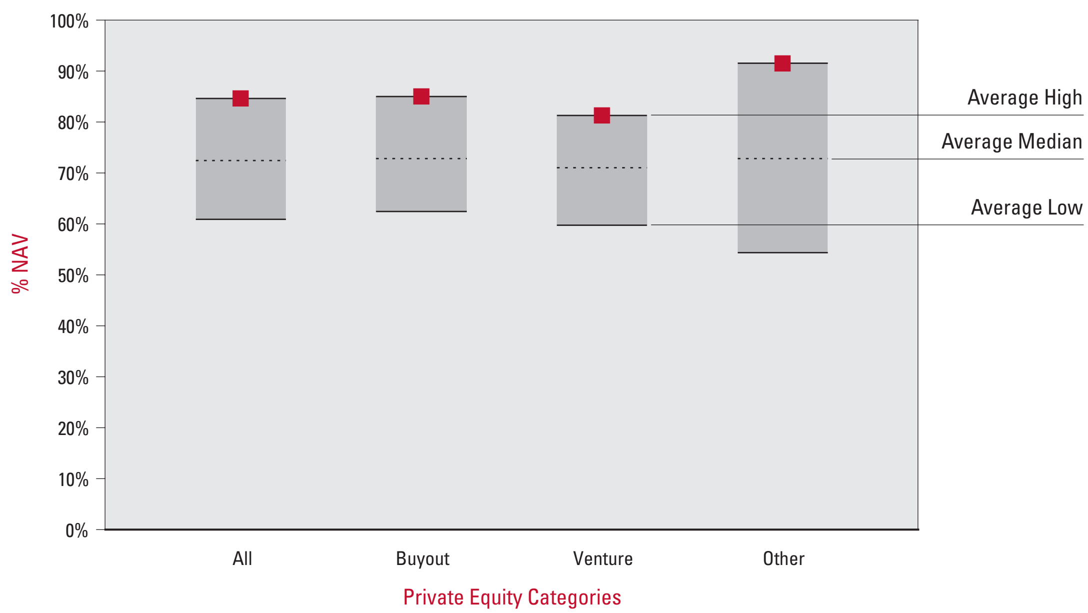
This study analyzes nearly 500 bids that Cogent Partners received on more than 200 funds marketed in the first half of 2008. The funds sold represent a diverse range in fund types (54% buyout funds, 31% venture funds, and 15% other funds), and while the sample consists mostly of North American funds (81%), it does include some geographic diversity (9% European funds, and 10% funds from the rest of the world). The analyzed bids represent the first round bids of a two-stage auction process. In cases where bidders submitted a pricing range in lieu of specific numbers, the midpoint of the range was used in the analysis.

The bidders during this period were diverse, but more concentrated in large fund-of-funds or secondary funds than in previous analyses. Historically the high first round bids are very indicative of the ultimate available transaction price at the conclusion of the auction process, and that has remained the case for the transactions that have been completed thus far in 2008.

Secondary Market Prices Down Significantly

As shown in Figure 1, the average high bid (the simple average of the highest individual bid received for each asset) across all assets in the sample was 84.7% of the net asset value, or NAV, reflected on the fund's most recent financial statements, with an average median bid of 72.4% of NAV and an average low bid of 60.9% of NAV. As is evident from Figure 2, the pricing represents a significant decline from 2007, when average prices remained above net

FIG. 1 Secondary Bid Spreads (H1 2008)



asset value. Prices fell to the lowest levels seen since 2003.

The decline in pricing for buyout funds was understandably impacted by the recent economic situation. The average high bid for a buyout fund was 85.0% of NAV, down from 108.7% for the full-year 2007 analysis, and from 107.0% from the second half 2007 analysis. Venture pricing fared similarly, with the average high bid falling to 81.3% of NAV from 102.9% of NAV for the full-year 2007, and 101.1% of NAV for the second half of 2007.

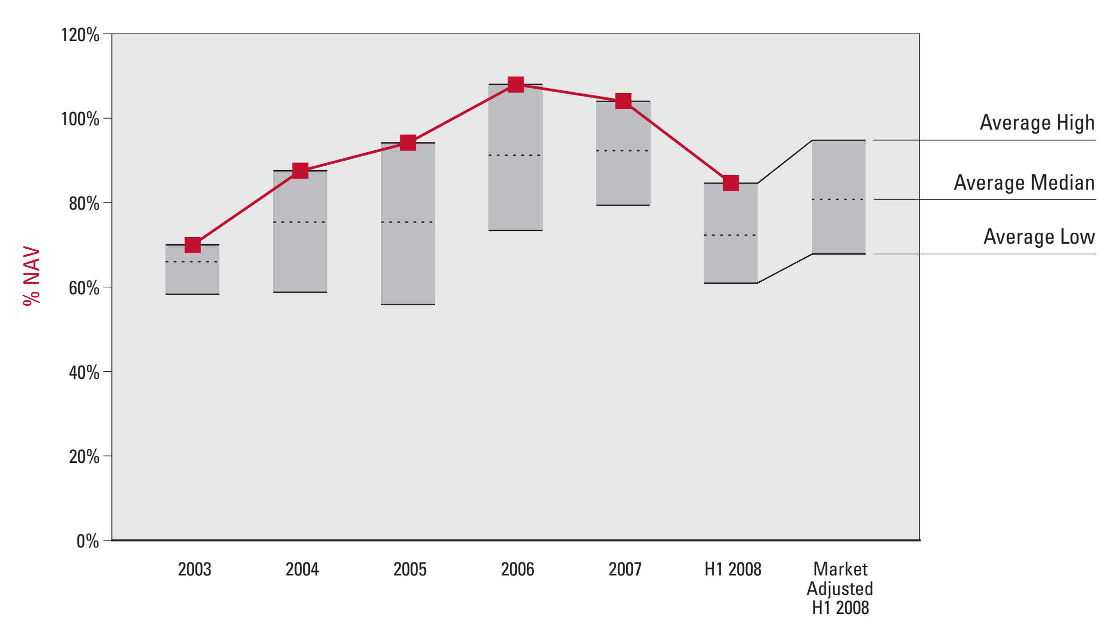
Pricing Spreads Widen

The changing economic environment reversed the slight tightening of pricing spreads the secondary market had been experiencing. As measured by the high bid as a percentage of the median bid, overall uncovering of the best price in the marketplace resulted in a price 17.8% above the median bid, while the low bid was 16.5% below the median bid. Interestingly, the gap between the high bid and the median bid remained fairly close to 2007 levels for both buyout (12.1% in first half 2008 from 12.6% in 2007) and venture (10.3% in first half 2008 from 9.4% in 2007).

Private and Public Market Pricing

The valuation lag in private equity cuts both ways. In the rising market seen in recent years, funds were able to transact above NAV due to 'conservative' valuation practices which were slow to recognize increases in portfolio value. In a declining market, the 'conservative' valuation process is revealed for what it is, less conservative than slow or static. While the public markets do their best to reflect the up-to-the-minute view of companies' prospects, sponsor valuations of private companies (mark-to-market rules notwithstanding) moderate the swings with a longer-term perspective. Sponsors are able to hold valuation steady even in the face of more senior securities in the firm trading at a discount. Even if valuations were truly marked to market, another pricing lag is inherent in the secondary market. Simply examining this private equity valuation time lag accounts for a significant portion of the decline. It should be kept in mind that the marketing of funds in the first quarter of the year likely used September 30 financial statements, which did not reflect the ramifications of the credit market crisis. In secondary transactions, the delay in valuation adjustment is corrected. To disaggregate the overall market's impact on pricing, we examined the decline in the broader public markets from the point of the last valuation of each fund to the time the bids for each fund were received. Given the change in an index between the NAV date and the bid date, the

FIG. 2 Secondary Bid Spreads Over Time



SUMMARY TABLE Secondary Bid Spreads by Fund Type

	% of Funds	Average High	Average Low	Average Avg	Average Median	Average Hi-Low	Average Hi-Median	% of Median	
								Average High	Average Low
% of NAV									
All	100%	84.7%	60.9%	75.4%	72.4%	23.8%	12.3%	117.8%	83.5%
Buyout	54	85.0	62.4	76.2	72.9	22.7	12.1	118.0	84.4
Venture	31	81.3	59.8	72.9	71.0	21.6	10.3	114.4	83.9
Other	15	91.5	54.4	76.5	72.8	37.1	18.7	124.8	76.8

NAV was adjusted to match the percentage change in the index over the same period. The original bid was then compared to this adjusted NAV to arrive at a value which uses public market movements as a proxy for changes in intrinsic value.

Using this metric, buyout funds priced at 94.8% of the public-market-adjusted NAV (using the S&P 500 as the public market benchmark). Effectively, this concludes buyout prices fell 5.2% more than the public market from the valuation date. Given that private equity-backed companies typically have a debt to total enterprise value ratio of double that of the S&P 500, the gap between the decline in the public market and the decline in private equity pricing seems insignificant.

The same analysis for venture funds (using the NASDAQ as the public market benchmark) indicates a larger decline, with the high bid representing 91.0% of the net asset value adjusted for performance of the public markets. The non-traditional funds in the sample (such as mezzanine, infrastructure and distressed debt) actually performed better than the public markets, with the high bid representing 105% of the net asset value adjusted for public market performance.

The analysis indicates that the fall in private equity secondary market pricing appears to be in-line with the public market, especially when debt levels are considered.

Fig. 3 Cogent Secondary Return Rate

	H1 2008		2007		2006	
	High Bid	Median Bid	High Bid	Median Bid	High Bid	Median Bid
Implied Rate of Return						
All	13.3%	21.6%	11.3%	21.8%	10.9%	21.2%
Buyout	13.1	19.6	10.8	22.5	9.8	19.1
Venture	15.4	25.3	12.0	23.2	11.5	23.6

Deteriorating Market Conditions

In the last few secondary pricing analyses, the golden conditions for secondary pricing were highlighted. Fund sponsors were very optimistic about the performance of portfolios, with expected near-term cash and positive outlooks allowing potential purchasers to be very aggressive in pricing assets. The opposite is now apparent. Discussions with fund sponsors reveal very little near-term liquidity, and guidance to lower return multiples over much longer periods of time with more uncertainty is a typical scenario. Simply incorporating the general partners' guidance results in lower pricing, holding a buyer's desired return constant.

The remainder of the decline in pricing is due to an increase in the secondary underwriting rate, the return bidders expect to achieve. As shown in Figure 3, plugging the high bid into Cogent's valuation models and solving for the expected return leads to a 13.3% secondary underwriting rate for all funds, up from 11.3% in 2007. This overall underwriting rate breaks out into a 13.1% underwriting rate for buyout funds (up from 10.8% in 2007), and a 15.4% underwriting rate for venture funds (up from 12.0% in 2007). While the underwriting rate has increased, the 2.0 percentage point increase seems very modest given movements in other markets, especially other illiquid assets. Over the same period, the yield on CCC corporate bonds increased 4.5 percentage points.

Selection Effect

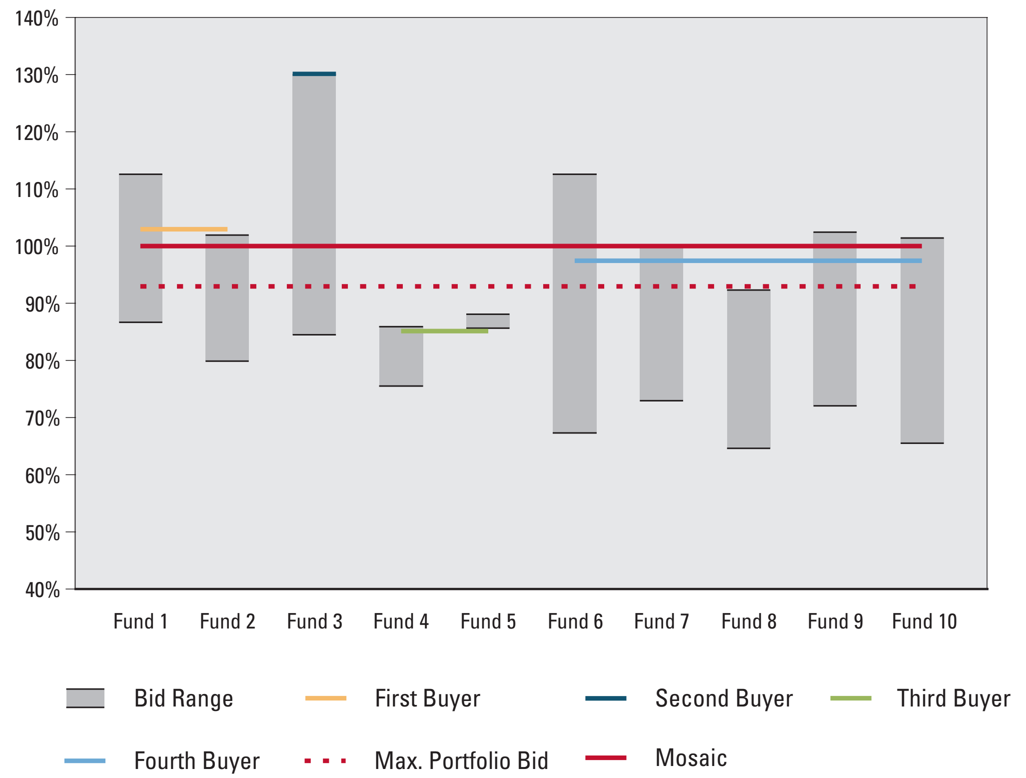
One other factor in the pricing decline is the role of fund selection in the data sample. As previous analyses have discussed, in the majority of transactions represented by Cogent in previous years, sellers have been strategic sellers, not motivated by a need for liquidity. The portfolios were formed to achieve strategic goals, generally subject to a constraint of achieving overall pricing close to NAV. The primary motivation has changed in the current environment. While distributions out of private equity portfolios have fallen, core relationships are now coming back to the fundraising market, excited by a buyer's market, and institutional investors up against their allocation targets are looking for the liquidity to commit to the new funds. An increased desire for liquidity has removed the absolute need to achieve pricing at or above net asset value for many transactions. Sellers are now thinking in a more economically rational way, weighing the pricing received versus other uses for the capital.

Complexity Trends

One other notable repercussion of the market uncertainty is the increased complexity of portfolio transactions. As the outlook for private equity performance has become less certain, buyers are being more selective in the funds for which they are willing to bid aggressively. This has led to an increase in the number of buyers necessary to achieve the best pricing for a portfolio, resulting in a decrease in the funds purchased per buyer from nearly 8 in 2005, to less than 5 in the first half of 2008.

Selling to a number of buyers as opposed to a single portfolio bidder can result in significant gains in pricing. As an illustrative example, Figure 4 details a recent disguised secondary portfolio transaction. While the highest bid on the aggregate portfolio has seldom been the absolute highest pricing versus selling to multiple parties, sellers have generally had to weigh moderate gains in pricing versus the additional complexity and risks of closing with multiple parties. In the current market environment, however, the gains from seller-organized syndicates are even more substantial. In this portfolio, the syndicate of 4 buyers (an average of 2.5 funds per buyer) produced a purchase price approximately 8% above the highest portfolio bid.

FIG. 4 Mosaic Pricing Analysis



The increased complexity needed to maximize pricing magnifies the importance of market knowledge and proper transaction management in a successful secondary sale. Bringing a portfolio to market by approaching two or three large bidders, hoping their competition will drive the best price, leaves significant value at the table. Allowing buyers to pick and choose the assets they will bid on without constraint will balloon complexity, and likely lead to a failed transaction with undesirable assets falling out of the transaction, or being priced by buyers who know the assets are orphaned. The current pricing environment has increased the importance of knowledge of buyer preferences, bidding history, and transaction strategy in executing a successful secondary sale.

Conclusion

The first half of 2008 has seen a sharp reaction in the secondary market to the overall shift in the private equity market. While assets are still being underwritten to rates lower that most institutional investors' hurdle rates, decreases in public comparables, pessimistic general partner guidance, increased buyer underwriting rates and liquidity-focused sellers have all combined to lower secondary pricing considerably. However, these factors have made the need for an experienced intermediary all the more apparent. As buyers prove increasingly unwilling to bid aggressively on a large range of assets, an intermediary that knows which buyers will put forth strong bids on the given assets in a portfolio can add substantial value. Only with such an advisor is a seller likely to achieve optimum pricing in the current market.

Cogent Partners is an international investment bank specializing in transactions of private equity secondary assets and the investment of alternative assets. The firm's clients include tax-exempt organizations, financial institutions, corporations and individual investors. Cogent Partners' depth of insight and analysis remains unmatched in the industry, as the firm draws on extensive experience and propriety tools to produce maximum value for clients. In its secondaries practice, Cogent Partners offers a full range of sell-side advisory services including asset valuation, buyer selection, legal expertise, and unique liquidity solutions.

Colin McGrady, CFA
Mr. McGrady is Managing Director in the firm's Dallas office, and is a co-founder of Cogent Partners. Mr. McGrady is responsible for all aspects of the firm's business, including engagement management, research development and strategic direction. He also heads the firm's Asset Management division.

Mr. McGrady earned an MBA from Harvard Business School and a BA in economics with a Japanese minor from Brigham Young University. Mr. McGrady is a CFA charterholder.

Brad Heffern
Mr. Heffern is responsible for assisting on all aspects of research, including preparation of materials, valuation and portfolio analysis. He is also responsible for assisting in client engagements, including valuation analysis, preparation of engagement materials and transaction marketing. He joined Cogent Partners in 2005.

Mr. Heffern holds an AB in mathematics and economics from the University of Chicago, and has passed all three levels of the CFA program, with a charter pending necessary work experience.

COGENT | PARTNERS

Dallas
100 Crescent Court
Suite 500
Dallas, TX 75201
Tel: 214.871.5400
Fax: 214.871.5401

London
35 New Broad Street
London EC2M 1NH
Tel: 44 207 194 7653
Fax: 44 207 194 7651

As of September 25th
we will be relocating to:
2101 Cedar Springs Road
Suite 1200
Dallas, TX 75201

Tokyo
5-14-23-404 Roppongi
Minato-ku,
Tokyo 106-0032
Japan
Tel: +81 (3) 3560-3373
Fax: +81 (3) 3560-3373

New York
400 Madison Avenue
20th Floor
New York, NY 10017
Tel: 646.274.4950
Fax: 646.274.4951

www.cogent-partners.com