

Private Equity

E-ALERT

December 4, 2008

Increased Activity in Secondary Market for Private Equity Fund Interests

The New York Times reported recently that a number of universities are trying to sell a portion of their private equity fund interests to generate liquidity and rebalance their "alternative asset" portfolios. As the Times article pointed out, endowments with assets of more than \$1 billion reported that 35% of their holdings were in private equity funds and other alternative investments on average last year, an allocation likely to be significantly greater than prescribed for these asset classes by the investment guidelines for the endowments. Harvard University has announced that its \$36.9 billion endowment fund lost 22% of its value in the last four months and that it has put \$1.5 billion, or about 38%, of its private equity holdings up for sale. Expect this trend towards increased sales of private equity fund interests to continue as other significant private equity investors, such as pension plans, financial institutions, foundations, hedge funds and funds of funds investors, follow suit.

Investments in private equity and venture funds, unlike investments in hedge funds, have several features that make them particularly onerous on investors in a tough market environment. The first is the investor's commitment to fund a fixed amount of capital at the outset for a period of years; the bulk of this capital is typically funded during the five to six year "investment period" of the fund (with the balance funded during the remaining term of the fund), and the unfunded commitment is shown as a liability on the investor's balance sheet. The second is the illiquidity and long holding period for the investment. The capital is invested in private companies with the expectation that over a period of three to five years the fund manager will be able to increase the value of the company and then exit the investment, providing investors with liquidity through proceeds of a private

- Endowments and other large institutional investors are seeking to reduce private equity fund exposure through increased secondary sales
- The long-term and illiquid nature of private equity fund investments, which allows for high returns in a good market, can make them more onerous in a tough market
- Secondary market transactions provide investors with liquidity, eliminate balance sheet liabilities for future capital calls and avoid penalties resulting from defaults in capital contributions
- Market activity has not yet become robust due to valuation and timing issues

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sale or an initial public offering. During the period that the fund holds the investment, there is limited cash distributed to investors in respect of the investment. The third is the investor's lack of redemption or withdrawal rights (except in the case of extraordinary legal circumstances). The fourth is the investor's obligation to contribute capital on relatively short notice from the fund manager to fund new investments, follow on investments and fees and expenses.

When there is liquidity in the market and portfolio company values are increasing, an investor can often rely on the cash distributions it will receive from dispositions or recapitalizations of, or dividends paid on, its early investments to satisfy its obligations to make capital contributions in respect of later investments or fees and expenses. The current credit crisis and the significant decreases in portfolio company values have made dispositions or refinancings of portfolio company investments next to impossible. In the absence of the distributions from refinancings or sales, or existing available capital, the best alternative for a fund investor often is to consider selling its fund interest in a secondary sale to a buyer that has capital to fund future capital calls and can afford to wait to receive the return of its investment. The alternative of holding on to the fund interest and defaulting on a capital contribution is extremely undesirable, as this is usually subject to significant penalties, such as forfeiture of 25-75% of the investor's existing capital account, deferral of distributions in respect of funded investments and other consequences.

Even though sellers are highly motivated to take advantage of the secondary market in the current environment, we have not yet seen a significant volume of secondary deals reported involving endowments and similar institutions. Two key reasons for this could be differing expectations between the buyer and the seller as to the value of the fund interests being sold, and the buyers' desire for protection against market and other changes that might occur between signing the purchase agreement and closing on the transfer, a process that can take several months.

Strategy for GPs

Fund managers should be aware of this trend as it will put pressure on portfolio valuations, create tension with existing limited partners and potentially inhibit future fundraising efforts. We believe that active dialogue with limited partners is the best strategy to reduce the impact of the potential sales. A GP who can line up potential buyers of LP interests may be in the best position to control the process.

As to valuations, since funds only determine their NAVs on a periodic basis (usually annually but some larger funds revalue on a semi-annual or quarterly basis), buyers are hesitant to bid on a fund interest until they feel the fund has appropriately marked down its portfolio investments as a result of the market downturn. It is the prevailing view that current fund valuations do not take into account reductions in value resulting from the economic crisis and that such reductions or markdowns will not be reflected until the 2008 year-end financial statements are available at the earliest.

As to market risk, these transactions often take a fair amount of time to consummate as written consent is generally required from the fund manager of each fund interest being transferred, and funds may require that transfers be made as of a quarter end. In this unsettled market, buyers are concerned about changes in market conditions after signing and before closing. Therefore, a material adverse change condition to closing, which has been uncommon in recent years and which sellers have typically rejected with success, has become more important to buyers as protection against possible changes in values, removals of fund managers and termination of funds, among other things.

Despite these risks, we expect that the liquidity these transactions provide will be very welcomed by institutional investors seeking to reduce exposure to private equity commitments.

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