

Big Squeeze Play

Capital calls are coming at the worst possible time for limited partners, already hurt by a plummeting stock market and paltry distributions from PE and VC funds

By Alexander Haislip, Senior Writer

The financial crisis is putting the squeeze on limited partners. Banks are unwinding their private equity assets to satisfy creditors. University endowments are looking to offload commitments on the secondary market. Pension funds are asking general partners for longer lead times on capital calls and leaning on beneficiaries for larger contributions.

While this is terrible news for limited partners, venture firms aren't expected to be negatively affected—unless they plan to raise a new fund next year. LPs are contractually obligated to meet their capital calls, so they will have to do whatever it takes to fund their commitments, even if it means selling their public equities at a loss or selling their venture fund stakes on the secondary market. If a venture fund can help out an LP—say, by slowing down its capital calls—then it might have a chit to cash down the road when the economy rebounds.

LPs are in a world of hurt. Consider a few data-points on one of the world's largest, most active pension funds: The California Public Employees' Retirement System (CalPERS) has lost nearly \$70 billion in the stock market in the past 12 months. What's making matters worse is that the pension fund upped its contribution to private equity and other illiquid assets as the markets were falling. It put \$5.1 billion into alternative investments during the first half of 2008, up from \$3.1 during the same period in 2007.

Those investments are typically paid for by distributions from the same pot. In other words, Peter's 2002-vintage buyout fund pays for the investment into Paul's 2008-vintage venture fund. But those payments haven't been forthcoming, at least not for CalPERS. It saw distributions from its alternative investments slip to \$2.3 billion during the first half of the year, down from \$2.5 billion during the same period in 2007.

Universities are having difficulties, too. Harvard University recently put \$1.5 billion in private equity commitments from its endowment onto the secondary market. Duke University is trying to sell \$1.3 billion worth. "The demand [from PE firms] on the endowment funds has gone up, just at the same time that they're getting less out of them," says David de Weese, a general partner with secondary investor Paul Capital. "It would not be unusual for an endowment to get \$250 million in gifts. A lot of that was coming from hedge fund investors who aren't going to be giving this year. The other big source of funds was the federal government. That's gone because the federal government is going through the same problems as everyone else."

Private school endowments are difficult to track. It's easier to see what's going on at a public university, such as the University of

Virginia. The school's endowment owns \$1.6 billion in private equity, real estate and other illiquid assets, with another \$1.8 billion in unfunded commitments to private funds. The telling part comes from what the endowment manager included in its September report:

"Under normal circumstances, we receive regular distributions from private funds and expect these distributions to exceed capital calls. However, in recent quarters we have received much lower distributions from our private funds than usual. In conversations with our private managers over the past two weeks, they tell us that the financial crisis precludes sales of existing investments, and we should not expect any distributions this quarter and few in 2009. None wish to forecast distribution activity in 2010 and beyond."

The endowment manager expects to get \$100 million in distributions from private equity and other private funds in 2009 and will fund its commitments by liquidating its position in hedge funds. It will also consider selling its stakes in private funds on the secondary market, but isn't optimistic. "Because bids for these illiquid investment assets are severely depressed in today's period of financial distress, the proceeds from a sale may be far below fair value," the management firm reports. Christopher Brightman, CEO of University of Virginia Investment Management Co., did not respond to a request for comment.

"This is a widespread issue," says Todd Miller, a managing director with secondary investor Cogent Partners. "It isn't just a few endowments. It is going to go through all the LPs at some point."

Miller goes on to say: "The world has changed and I don't think people get this. Things are much different now than they were on Sept. 1. Everything is worth 30% to 40% less than it was in June because multiples are lower."

The problem is simple: Public market gains could support ever-increasing allocations to venture and buyouts, but as the market falls, LPs face serious problems. Some will beg off their capital commitments or demand longer lead times on capital calls. Some will sell their stakes at an ever-rising discount on the secondary markets. Many won't be putting money in private equity again any time soon.

Dialing for Dollars

At least one major limited partner has gone on the record to talk about its capital crunch. "We called the [private equity] partners for our planning purposes, and we are coordinating [the] timing of those

[capital] calls with them,” says CalPERS spokesperson Patricia Macht. “We don’t comment on specific investment transactions, except to say that in down markets, we manage our cash as appropriate for the situation.”

CalPERS is an investor in well over 150 venture funds, including vehicles raised by such well known firms as Austin Ventures, DCM, Draper Fisher Jurvetson, Highland Capital Partners, Index Ventures, Institutional Venture Partners (IVP), Lightspeed Venture Partners, Menlo Ventures, New Enterprise Associates, North Bridge Venture Partners, Oak Investment Partners, Redpoint Venture Partners and U.S. Venture Partners (USVP).

It isn’t clear if CalPERS has asked any of those firms to delay a capital call. Partners of at least four firms backed by CalPERS—IVP, Lightspeed, Trident Capital and USVP—say none of their LPs has asked them to delay a capital call or slow their investment pace. “We just did a capital call and there were no issues whatsoever,” says Todd Chaffee, a general partner with IVP, which recently participated in one of the biggest VC deals ever—a \$250 million investment follow-on for vacation rental portal HomeAway.

Only one of 15 VCs VCJ contacted for this story said his firm had been approached by an LP asking for any help the venture firm could give it. The LP has seen the value of its liquid securities decline from about \$2 billion to \$1 billion and is now concerned that it won’t have the cash to fund \$1.5 billion in commitments to VC and PE firms, says the VC, who asked not to be named.

To make certain it has cash, the LP is begrudgingly selling stock and pulling money out of hedge funds. It has also reached out to every one of its fund managers to let them know about its situation and ask for their help, the VC notes.

The LP doesn’t want to have to sell its stakes on the secondary market, so it’s asking funds to transfer parts of its commitments to other LPs, the VC says. In the case of this particular venture firm, the LP committed less than \$20 million and is looking to reduce its commitment by 50% to 75 percent. Though the commitment is relatively small, the LP is “looking for scraps anywhere they can,” the VC says.

But the LP liquidity crunch may miss many. “There are a few funds having trouble calling capital, but that’s a real exception,” says Josh Tanzer, a managing director at investment bank Revolution Partners. “I’d guess that 90% of funds have no problem calling capital.”

The reason? It’s because the only limited partners who will actually be able to affect change in their portfolio companies are the big ones. “It ain’t going to be the people we’ve never heard of before doing this,” says Tanzer. “It’ll be the guys with clout.” That means only the largest pension funds and endowments.

Even then, most VC funds have a diversified base of limited partner investors. Sequoia Capital’s 11th fund had 65 different LPs, according to a regulatory filing. The firm’s Mark Dempster declined to comment

on whether the firm’s limited partners had stipulated any change to the way Sequoia makes its capital calls.

So who’s going to get hurt by this? Buyout funds. They’re typically making bigger capital calls than their VC counterparts and may suffer from a crisis of confidence from their LPs.

Who’s Happy? Secondary Investors

There’s no better time to be a secondary investor as when the rest of the market is going to hell. But secondary investors’ gain is LP’s pain.

It should be no surprise that the pace of secondary deals has quickened, signaling how desperate both firms and limited partners are to offload their commitments. “Across all of 2007 we couldn’t get a deal done,” says Ken Sawyer, a Managing Director at secondary investor Saints Capital. “We lost deal after deal after deal because we couldn’t agree on pricing. We put a total of \$22 million to work all year. This year we’ve committed over \$300 million.”

Saints was lucky to close its sixth fund at \$300 million in May because it’s seeing better pricing on deals now than ever before. “If you’re desperate, it’s a desperate time,” says Sawyer. “It’s ugly for anyone who needs capital right now.”

The first half of the year was already pretty bad, with the winning secondary bid for private equity holdings hitting 84 cents on each dollar of Net Asset Value (NAV), according to a September report by Cogent Partners. “Now it’s probably more like a 40% discount,” says Cogent’s Miller.

“We’re starting to see write-downs in Q3 and will see even more in Q4,” Miller predicts. “Everyone thinks this is a big story, but it can’t be a big shock unless you have had your head in the sand. This isn’t getting better anytime soon.”

LPs holding top quartile funds aren’t getting hit as hard, says Larry Allen, managing member of NYPPEX Private Markets, a firm that offers a market to secondary investors. The average price for a top-quartile fund was 90.1% of its NAV in October, down from 100.07% in 2007, Allen says. That’s not nearly as bad as what’s happening to LPs holding funds in the bottom quartile. A year ago, those funds traded at 54.8% of their NAV, but they now trade for 34.3% of their net asset value, Allen notes.

Prices are falling due to the imbalance between the supply of private equity assets and the ability of secondary funds to fill that demand. “There’s a huge supply-demand imbalance here,” says Paul Capital’s de Weese.

Paul Capital has estimated that banks, endowments and pension funds have put about \$130 billion worth of private equity commitments on the secondary market. But secondary investors have raised only \$25 billion in the past two years, and Paul Capital estimates that half of that has already been committed. That means that the supply of private equity assets for sale is 10 times larger than the amount of capital potential buyers have to invest.

The supply-demand imbalance drives down secondary prices, but so does limited partner desperation. For example, pension fund managers can face penalties for missing allocation targets. "For some institutions, the certainty of getting the deal done by a certain date is more important than the price," says de Weese.

Most of the action in the secondary markets is in snapping up commitments to buyout funds. That's the product of both the supply of buyout funds available and deep discounts due to the lack of cheap debt financing. Paul Capital, for example, will likely allocate 90% of the \$1.65 billion secondary fund it raised in May to buyout funds. That's up from the 70% it put into buyout funds from its last fund.

It generally takes more time and effort to evaluate a VC portfolio or venture-backed company, and secondary investors are currently stretched to the limit. "For secondary investors, it's like drinking from a fire hose," says Faruq Ahmad, who works with VC firms to help them connect with secondary financing. "The volume of deals has ramped up so much, and the secondary funds are not staffed up enough to evaluate each deal. It's really not worth the time for some of these secondary funds to put in the energy, especially when you can put in less effort and get a much better immediate return on buyouts."

The market for individual venture-backed companies may be even worse: The average price for a performing private company is about 55% of the seller's fair value, down from 89% a year ago, according to data from NYPPEX. "When you're looking at a venture fund's portfolio, the pricing of those portfolio companies is more driven by the credibility of the GP than the underlying numbers of the company," says Allen.

Secondary market prices are going to fall even further. "The problem is that many buyers, maybe half, believe that price is declining for the next six months," Allen says. "One out of two buyers we approach today pass."

Part of the reason would-be secondary buyers are passing is that venture firms and buyout shops have yet to internalize net asset value write-downs. Prices today are based on valuation estimates made on Sept. 30, before the public markets went completely south. Allen predicts that secondary buyers won't be back in the market in earnest until after the end of the fourth quarter.

Nightmare on Fund-Raising Street

When LPs can't get out of their commitments fast enough, it's hard to imagine venture firms and buyout shops raising a lot of money in 2009. "Every LP, I don't care who you talk to, believes liquidity is king and everybody wants liquidity," says Cogent's Miller. "Nobody is running out to throw money at GPs right now. The fund-raising market is going to come to a halt for the foreseeable future."

It's difficult for anyone to make long-term commitments when the Dow Jones Industrial Average can fluctuate more than 900 points in a day.

But exactly how bad is it going to be?

A VC who recently spoke to AlpinVest, which has about \$51 billion invested in venture capital and private equity, says he was told: "We aren't making commitments to venture funds right now unless it's a manager that we have a long history with. We're only active—but very active—in the secondary market. In fact, we are pulling people and resources from me and my group to work on secondary opportunities."

AlpinVest speculated that commitments to venture funds could fall to as little as \$12 billion in 2009. That would be a huge decline. U.S. VC funds raised a little over \$24 billion in the first three quarters of 2008 and about \$35 billion for all of 2007, according to Thomson Reuters (publisher of VCJ) and the National Venture Capital Association.

One thing working in favor of venture funds is that history shows that buyout funds and venture funds have operated countercyclically. Since buyout funds have racked up a few good years, it may be time for LPs to allocate away from buyouts and toward venture.

The best firms won't have any trouble raising their funds, of course. Remember the statistics from NYPPEX: Top quartile funds are trading down a mere 10 percent. That's really impressive when public equities are down nearly 40% across the board this year. Some LPs might look at their investments in top quartile venture funds as a safe harbor as the financial crisis roils the rest of the market.

The venture firms that should be worried are those that are low on capital but don't have a successful track record to convince LPs to commit to a new fund. There are still quite a few such firms. They've been limping along for years, hoping for that one big exit. The financial crisis may deal them a death blow.