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Dealing in difficult markets

One of the largest secondary deals of the year, the sale of Merrill Lynch's stake in venture debt firm Kreos Capital was also one of the most difficult and unusual transactions of recent times.

The secondaries market in 2009 has been characterised by one thing: paralysis. The previous year ended with a lot of discussion about the explosion of deal flow ahead, as struggling LPs turned to secondaries investors to offload unwanted fund positions. The reality is that the sellers are there, but no one's buying. Price expectations have failed to reach parity, and the market is at an impasse.

To get a secondary deal done in the current climate takes a lot of hard work, as Kreos Capital and its advisor Azla found out.

Kreos Capital specialises in venture debt, a form of lending available to venture capital-backed start-up and growth companies, and it gives investors exposure to venture investments but with a lower risk profile because of the structured debt repayments. Previously known as European Venture Partners, the firm launched in 1998, and following two successful fund raisings, launched it's third, Kreos III, in December 2006.

The fund closed in April the following year on €200m and was accompanied by the firm rebranding itself as Kreos Capital. The new fund began with just a single investor, Merrill Lynch. Simon Hirtzel, chief operating officer of Kreos Capital, said: "The €200m fund is invested way beyond that level with a loan book of around €350m. There is also a significant pool of upside in the warrant portfolio of stakes in VCs."

Merrill Lynch and Kreos were in the market to diversify the fund's investor base in 2007 and 2008 when the largest financial crash in history took place, sending the deal off-track. In September 2009 Merrill Lynch, a 94-year-old Wall Street institution, fell victim to the credit crunch and was taken over by Bank of America for US$50bn in stock. This perfect storm of financial crisis and new ownership cast an inky shadow over the underlying portfolio valuations.

Despite the unfavourable circumstances, the Kreos team with Azla Advisors on board were able to sell a large chunk of Merrill's position and bring in five new investors – Paul Capital, AIG PineStar Capital (the secondaries team at AIG Investments), HarbourVest Partners, Access Capital Partners and SVB Financial Group – for €150m.

Changing motivations

This unique deal was, in fact, closed twice. Azla Advisors was mandated with expanding the investor base in November 2007 and the process was completed in September 2008 with HarbourVest acting as lead investor to 12 to 15 private equity firms in an oversubscribed close.

Then the crash came and Merrill Lynch was sold to Bank of America and there was a renegotiation of the terms and prices and pretty much everything else. All the Merrill Lynch approvals had to be redone for Bank of America approvals. A new lead investor, Paul Capital, emerged and repriced and restructured the deal.

Roman Kogan, director of Merrill Lynch, said: "Our motivations as a seller changed. Originally we were very interested in venture debt and asset aggregation of venture debt assets. We wanted to ramp up the portfolio and then exit in some fashion. With signs of deterioration in the macro economic environment, our motivations became centred on closing the transaction, though the economics were not as compelling and the bid-offer had widened significantly. In October, we found an acceptable level for all parties with performance downside protection, which complicated matters even more."

In order for the seller to be able to secure the price that it needed to meet internal requirements – with poor economic conditions and uncertainty about the future upside achievable on the warrants – the buyers needed protected returns. The syndicate employed a creative solution. The downside protection is based on a performance multiple threshold that is reasonably achievable by the fund. It will be reviewed midway through the remaining life of the fund in 2013. At that point, if the performance has not been achieved, Paul Capital, SVB, HarbourVest, AIG and Access will be due a clawback on the price paid in 2009.

Peter Wilson, managing director of HarbourVest, said: "The key challenge in a deal is to maintain balance between the buyer and seller. Ultimately we found a way to bridge the gap for the syndicate. The downside protection helped maintain balance and get it done."

The Azla challenge

From the beginning, Azla Advisors realised the nature of the venture debt asset class would take a certain valuation methodology: bottom-up and detailed company-by-company. Azla also extrapolated future performance for the warrants.

David Waxman, managing director of Azla Advisors, said: "We used a credit valuation model and an equity valuation model to narrow the gap on the discount window. We performed five metric tests on each model. There was a heavy burden on the GPs to provide information but Kreos was very helpful."

As Kreos III was still in the process of investing and also actively managing the portfolio

through the downturn, the fund was constantly changing and evolving.

HarbourVest's Wilson said: "This valuation approach alongside the intense write-up and model helped us to get our teeth into the transaction. The process was difficult because of the asset recycling and new companies added through the process. We spent time early on figuring out if the partners at Kreos had done what they said they would do. Positive feedback whets your appetite."

An unusual deal in an unusual asset class, the Kreos III transaction stands as an almost unique secondary deal in European history, made all the more difficult by the economic environment that was taking place around it.