Two Q's and Two A's On One of the Biggest Secondary Deals This Year

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In a deal that defies the stilted secondary market, Merrill Lynch yesterday sold €150 million worth of shares in Kreos Capital, a European venture debt fund manager. The buy-side group included Paul Capital, AIG PineStar Capital, HarbourVest Partners, Access Capital Partners and SVB Financial Group.

Alongside the spinout of Lehman Brothers venture arm (advised by Harbourvest Partners), it is one of the largest secondary transactions to close this year. I spoke with the deal's sell-side advisor, David Waxman of Azla Advisors, on where the deal stands in the greater secondary market.

How does this deal fit in with the general market activity?

The gap between buyers and sellers is wide because it is so tough to value equity at this stage. There is a feeling in the secondary community that NAVs do not yet reflect the full value of the writedowns, and so it's difficult for them to offer much for the LP interests. There's even a debate over whether secondary investors should stay away from '06-'07 vintage private equity funds altogether.

In this deal, we started working with Merrill Lynch two years ago. Merrill planned to be the sole sponsor of Kreos for two years and then divest 75% of holding on secondary market.

So how was this deal able to close? Were there no bid-ask spread issues?

For one, it's a good time for venture debt now. The loans are being paid back by the Kreos Capital portfolio companies. Kreos does not lend a company money unless there is a top tier venture investor investing alongside them and they can see clearly when they'll get their money back. The return is not dependant on economic performance.

Because of that, bidders were able to bid at a price much closer to par. There’s strong downside protection in venture debt. Also, there was a fair amount of structuring built into this transactions that enabled the IIR to drive the transaction. They were able to generate a high IRR because the capital comes back in this deal in three years. The fund is 100% called, but the recycling period is four years.

(Bonus Q) So the fund hasn’t been significantly written down?

It’s being held above cost. The projected IRR is well over 30%.