Interview:
David Waxman, Managing Director, Azla Advisors

Azla Advisors, a leading boutique secondary sell-side advisor, recently closed a €150m divestment of Merrill Lynch's stake in Kreos Capital III to five top-tier limited partners in a challenging environment. Preqin's Tim Friedman talks with David Waxman, managing director at Azla Advisors, about the transaction.

TF: What was motivating Merrill Lynch to sell a large part of their interest in this fund?

DW: It was actually something that was part of the original deal that Kreos made with Merrill back in 2006 when it served as the sole sponsor for this fund. They were to provide 100% of the initial investor capital, and would then agree to divest 75% of their stake within two years so that Kreos would have the opportunity to form lasting relationships with a broader base of limited partners.

TF: Tell us more about the fund. What are some of the key attributes and characteristics of Kreos III?

DW: Well as previously mentioned, Kreos III is a €200 million fund focusing on the European venture debt market. The fund is already fully invested and, differently from other private equity investments, rather than exiting investments in a traditional distribution structure, any capital distributions are instead recycled for a four year period back into the fund in order to provide a higher multiple. During this period the investor will receive a 5% annual coupon. This structure provided a challenge in itself, as we had to help the potential purchasers understand the nature of the distributions, but the projected 20% plus IRR returns and strong downside protection offered by the venture debt sector meant that we were able to present a strong case for investment.

TF: Valuations can be notoriously difficult to justify and we believe that the widening gulf in the bid-ask spread has been one of the leading factors in the relatively low level of activity in the sector, bearing in mind the heightened interest from the media, investors and potential sellers alike. How were you able to convince the investors of the value of this fund?

DW: There were three important factors leading to the success of this transaction. Firstly, the strength of the venture debt sector was a driving force. The nature of the asset class allows for the generation of strong returns, with this vehicle having the added bonus of a 5% annual coupon. There is strong downside protection, with the venture debt sector being different to other similar sectors such as mezzanine in a couple of key ways: Venture debt players are holding more senior, and therefore less risky, debt positions than mezzanine players, and as they are investing in the top-tier portfolio companies of the top-tier European VC funds, who tend to support their portfolio companies' future funding rounds, the loan payback is less prone to effect from the prevailing economic conditions. Accordingly, venture debt can prove to be an attractive proposition for investors, even in the current uncertain times that we are facing.

The second important factor which is unique to the secondary advisory space is that our valuation methodology focuses on "discovering and demonstrating" hidden portfolio value. While valuing the Kreos portfolio, we dived into the 75 underlying investments made by the fund, looking at all the portfolio companies, performed credit tests to generate company credit ratings and built a warrant valuation model based on interviews with the GP and the key portfolio company CEOs in order to really understand the true value of the fund, which often can be lost in the reported NAV. The result was that we were able to prove and justify the true value of the fund, leading to a purchase price that was acceptable to our client with much better results than has been the case in most other recent secondary transactions. This approach has led to a 100% success rate in our sell-side assignments over the past three years, with the high-bids on our transactions being 32% higher than the industry benchmark.

The third factor was the creative structuring approach that all the parties in the transaction worked with us in crafting. We were able to structure the transaction in a way that was beneficial for the seller, by limiting future LP capital calls and enhancing IRR.

TF: What was the timeline on the deal?

DW: We actually started working on our due diligence on the Kreos portfolio back in late 2007 in the pre-credit crunch days, and began marketing in the spring of '08, so we have really encountered a number of challenges before successfully completing the deal last week. We had the transaction in place by the summer of 2008, but as we were completing the legal processes, the Lehman Brother bankruptcy and the subsequent

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tumult in the financial markets led to a number of new obstacles to say the least. Ultimately, with the help and support of the team at Merrill, Paul Capital, who led the buying syndicate, Kreos, and all the attorneys involved, we were able to work together to reprice and restructure the deal and be in a position to announce the closing last week in early May 2009.

TF: Thank you.

Azla Advisors can be reached at www.azla-advisors.com

Tim Friedman