Stockholm School of Economics
Master's Thesis in Finance

Niklas Rosencrantz 17071@student.hhs.se
Yu Jiexing 80237@student.hhs.se

October 2006

Secondary Private Equity Portfolio Transactions in Sweden

ABSTRACT

We have researched secondary private equity portfolio transactions in Sweden during the last 7 years. We start by studying the structure and functioning of secondary private equity transactions in mainly Anglo-Saxon countries. We then report case studies and interviews covering the main secondary private equity portfolio transactions in Sweden during the last 7 years. The results of our research suggest that the secondary private equity portfolio market will evolve also in Sweden. However, the first dedicated secondary private equity portfolio manager in Sweden originates from Norway.

Tutor: Prof Paolo Sodini
Discussion: October 9, 10:15, Room 750

Acknowledgements

We would like to express our gratitude to our tutor Prof Paolo Sodini for providing helpful assistance and important advice along the development of this study. We also feel much indebted to the interviewees who dedicated valuable time to help to convey to us their experience and opinions on this subject.

TABLE OF CONTENTS

1. INTRODUCTION

In general, private equity funds are closed, so reselling private equity shares early in a secondary transaction is complicated and normally generates significant discounts[1]. The secondary private equity market is a relatively recent phenomenon in the private equity industry and focuses on the transactions of fund shares or entire portfolios of direct investments. These investments were primarily entered into by organizations such as banks and insurance companies, industrial corporations and professional investment houses or wealthy individuals. Their rationales for entering their primary investments ranged from buying a "window on technology" to the pursuit of higher returns by taking undiversified direct investment risk.

Most private equity investors' strategies were severely tested following the market downturn beginning in 2000. Against the background of falling markets and negative investment returns, some (especially more recent entrants) decided to withdraw from the private equity asset class. For many of these investors, attempts to follow through on their exit decisions have since been frustrated by continued unfavorable market conditions, on the one hand, and a lack of control and poorly aligned interests among investees and co-investors, on the other hand. Many investors have sought a more manageable way of disposing of private equity holdings - the sale of an entire portfolio, a so-called secondary direct transaction.

It is estimated that secondary private equity funds in the US 2004 represented an aggregate capacity in excess of USD 18 billions up from about USD 1 billion in 1996[2]. As secondary private equity transactions continue to grow our interest was prompted in trying to study the secondary private equity portfolio market in Sweden with a special focus on secondary directs.[3]

[1] Holger von Daniels: Private Equity Secondary Transactions, 2005
[2] Morgan Stanley: Special situations, March, 2005
[3] Boston Business Journal, February 20, 2004

2. BACKGROUND

The secondary private equity market is very young and – in line with the Venture Capital market some years ago – the meaning of words and concepts may still vary between different countries, institutions and authors/readers. The definitions that we will use throughout this report are depicted in Fig 1, 2 and 3 below. Fig 1 shows the two groups of corporate equity capital. Fig 2 shows one way of defining the private equity market by structuring it through its actors in early stages (Venture Capital and Business Angels) and late stages (Buy-out capital.) In Fig 3 the structure and participants in the private equity funds market can be seen.

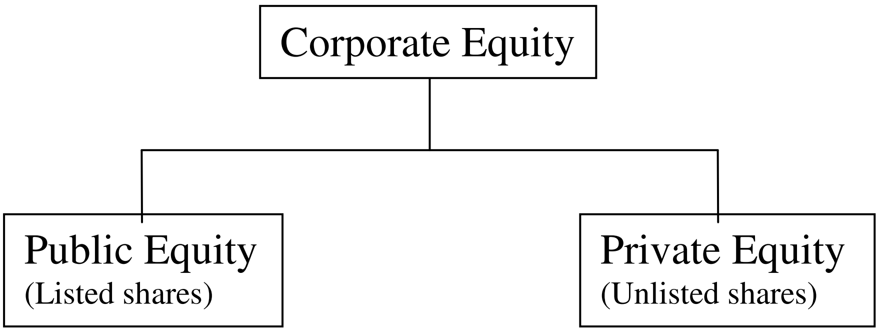

Fig.1 The two groups of corporate equity

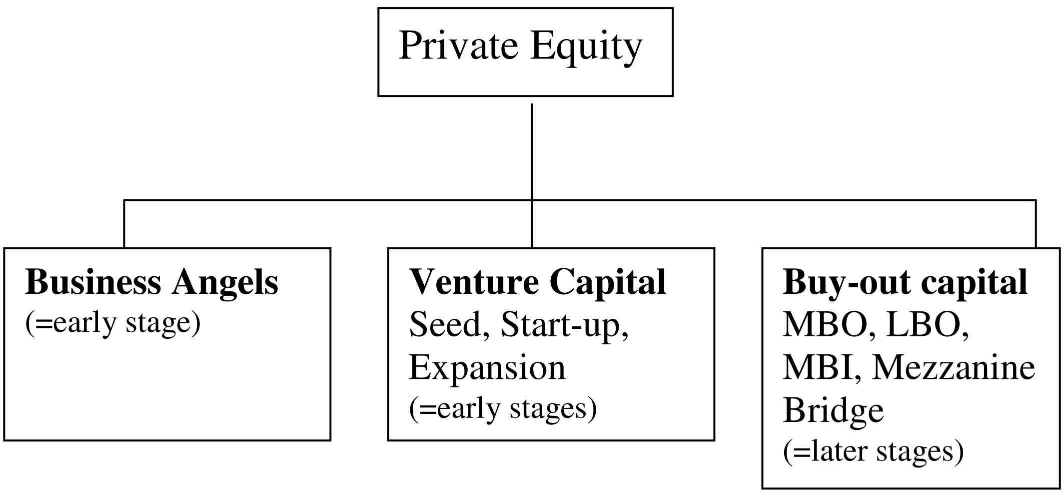

Fig. 2 One way of structuring the private equity market[4]

[4] SVCA year book 2005-06, page 2 & 16

Fig 3 illustrates the structure and the participants in the private equity funds market. Money flows from investors, also called Limited Partners, such as pension funds, insurance companies, banks and private corporations or individuals either directly to one or several private equity funds or indirectly through a fund of funds intermediary. The General Partner carries the management responsibilities for the funds but usually owns only a very small – if any – part of its capital. Each PE-fund invests its money into a portfolio of companies. A secondary transaction takes place when either shares in the PE-fund (or fund of funds) change hands or alternatively when the PE-fund sells all or part of its portfolio holdings. This later transaction is called a secondary direct transaction.

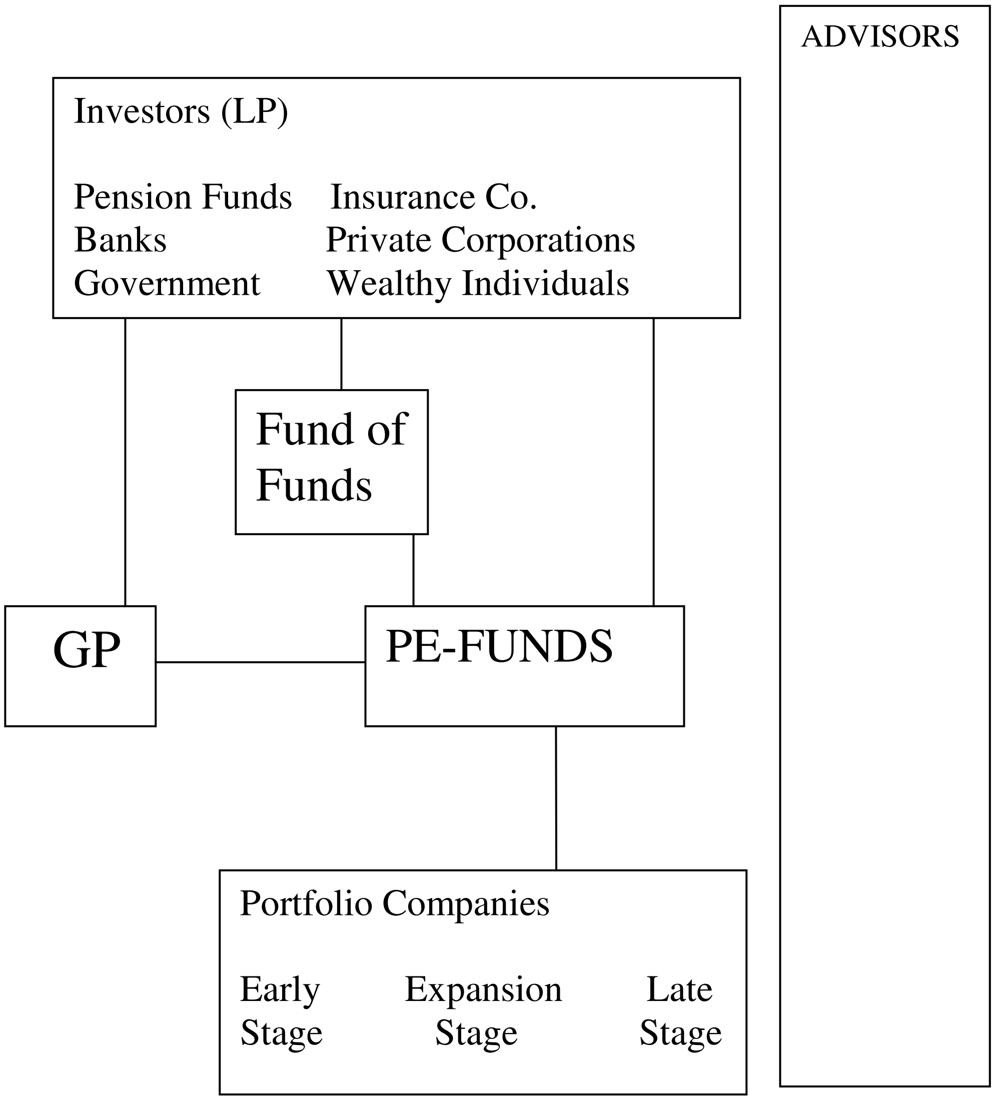

Fig. 3 Structure and Participants: the private equity funds market[5]
LP=Limited Partner, GP=General Partner, PE=Private Equity

[5] Holger von Daniels: Private Equity Secondary Transactions, 2004, p 17

Large financial investors such as insurance companies and banks were the first institutions to start to divest their direct investment portfolios, often driven by changes in the regulatory environment or because of the perceived difficulties associated with effectively managing a large portfolio of direct investments. The frequency of such deals increased after the 2000 market downturn.

The secondary private equity market started as a financial product which would have multiple characteristics other than mutual and closed-end funds. There are several reasons why secondary private equities have become successful financial instruments. As a further background we will below describe how a “secondary” transaction involving fund shares or an entire fund portfolio relates to open-ended funds and closed-end funds.

2.1 Closed-end, open-ended and secondary funds

A ***closed-end fund*** usually has limited life and is not listed on a public exchange. Investors in closed-end funds will get their capital plus any profits at a predetermined time.[6] The history of closed-end funds began in 1893, more than 30 years before the first mutual fund was formed in the United States. Quite a few closed-end funds have more than half a century of management and performance histories and have been handed down from one generation to the next. An investor in closed-end funds can transfer his interest in the fund (shares, partnerships interest, etc) to a third party with whom he has to negotiate a mutually agreeable price. Now more and more closed-end funds in the US and the UK are listed on the public exchanges to enable willing sellers to transact to willing buyers.

An ***open-ended fund*** is established with unlimited life and may very well be listed on a public exchange. It is a financial intermediary that allows a group of investors to pool their money together to meet their common investment objective—to make money. Instead of investing in a single stock, the investors invest in a portfolio of securities established by a fund manager.

An investor in an open-ended fund has the right to demand at his discretion the

[6] Timothy Spangler: A Practitioner’s Guide to Alternative Investment

redemption of his interests in the fund at the net asset value of the fund at that time. In this case, the investor in an open-ended fund does not need himself to identify a potential buyer and negotiate a price in order to obtain the liquidity of his investment. And it allows the investors to partake in the same fund at any time of their choice. Open-ended funds can be purchased or redeemed at any time, not necessarily on the stock market, but directly between shareholders or through a representative.

When closed-end funds are listed on a public exchange there will be a clear price quoted regularly. This price reflects the sentiments of the market which is mainly determined by investor demand and supply. In relation to the net assets of the fund the pricing of the fund can reflect over- as well as under-valuation. The underlying assets of the fund remain unchanged when the investor finishes the transaction. Open-ended funds have no limit to the number of shares the fund can issue. Nor is the total market value of the fund affected by the number of shares outstanding, because net asset value is determined solely by the change in the price of the stocks or bonds the fund owns, and not the size of the fund itself.

Secondary funds will buy shares in a closed-end fund at some time after its portfolio has been established from the primary investors. The share price may drop below the net asset value and thus the owners will be selling at a discount. This discount is the difference between the market price of the closed-end fund and its total net asset value. If the stocks in the fund decrease in value, the discount decreases and may become a premium instead. Liquidity is usually quite poor in the closed-end fund, so seasoned investors in secondary funds can sometimes pick up stocks of a fund at a good discount when comparing stock market value to net asset value.

The private equity market is comparable to a closed-end fund, not listed on the public exchange, and with very limited information to outsiders. Practically no interim liquidity is provided to investors by the fund itself. Stocks are very illiquid and if traded at all they will yield significant discounts. The secondary private equity market derives from the fact that many investors in closed-end funds require liquidation before the end of the fund life.

All secondary private equity transactions are quite complex, for example, the process of potential buyer identification, the valuation of the fund, and the legal issues involved. As a consequence of the strong growth of US secondary private equity activities there now exists since 2003 a new securities exchange, the NYPPE (the New York Private Placement Exchange) which offers an institutionalized on-line based market place for secondaries.[7]

3. OBJECTIVES

Objective 1: Our first objective is to understand the status and indicate some future development trends for the secondary private equity portfolio market in Sweden and to observe possible differences compared to the recent dynamic developments in the US.

Objective 2**:** In the US, there has emerged an institutionalized market exchange, the NYPPE (The New York Private Placement Exchange) – which serves the secondary private equity brokering needs. Our second objective is to study whether a similar exchange can be expected to be established also in Sweden.

Objective 3**:** Our third objective is to discuss whether Swedish private equity companies in the future are likely to structure their portfolios in such a way that they will be tradable as portfolios of secondaries.

Objective 4: Our fourth objective is to study the valuation process involved in the secondary private equity portfolio price assessments in Sweden.

4. METHOD AND DATA

4.1 Descriptive approach

We have taken a descriptive approach of secondary private equity portfolio transactions in Sweden by first studying the structure and function of existing international secondary transactions in section 5 to provide the foundation for the analysis. In section 6 we report our findings on the issues of valuation and transaction techniques. In section 7 we report our specific study on Sweden where we have performed a number of case studies mainly through interviews. We also include an interview with Cogent Partners in London. This leads us to conclusions in section 8 and suggestions for further research in section 9. We have chosen to place the details of our case

[7] Holger von Daniels, Private Equity Secondary Transactions, 2004, p 228

studies and interviews in the appendices, section 11. Printed references have been of limited use but we have found useful information using the internet and both these groups of references are to be found in section 10.

4.2 Canned data sources are unavailable

It is important to note that performance records in private equity are not at all available in comparable volume as from listed companies. Quoting from our interview with Skandia Liv: "Private equity is private, so you can't rely on statistics." We further noted from Skandia Liv the following 3 arguments against attempts at applying traditional data analysis of this financial segment:

- Sample size is too low.
- There is self-selection in reporting.
- Disturbances are created by survivorship bias.

5. SECONDARY PRIVATE EQUITY PORTFOLIO TRANSACTIONS

5.1 General Partners and Limited Partners

Figure 4 shows a typical secondary private equity transaction. In the secondary private equity market the general partner (GP), who usually is the manager and organizer of the fund, has a management contract with the initial investors of the fund, the so-called Limited Partners (LPs). The secondary fund investors are investors who buy securities portfolios from fund owners (LPs) who sell earlier than the maturing yield of the portfolio. Such transactions are called 'secondaries' because the purchase and sale of the asset is occurring a second time following its original issuance. The contract is individually negotiated and documented between General Partners and Limited Partners with little standardization. Several reasons exist for wanting to sell early such as the yield of the portfolio, "over-allocation" to the asset class on account of the deterioration in value of public markets, changes of management, changes of ownership, changes in the regulatory environment, and/or need for liquidity. In these cases the Limited Partners may want to sell their shares to a secondary fund buyer in an open bid/sealed bid auction type market. Negotiated transactions, electronic postings are also alternative ways to reach a liquidity solution besides auctions.[8]

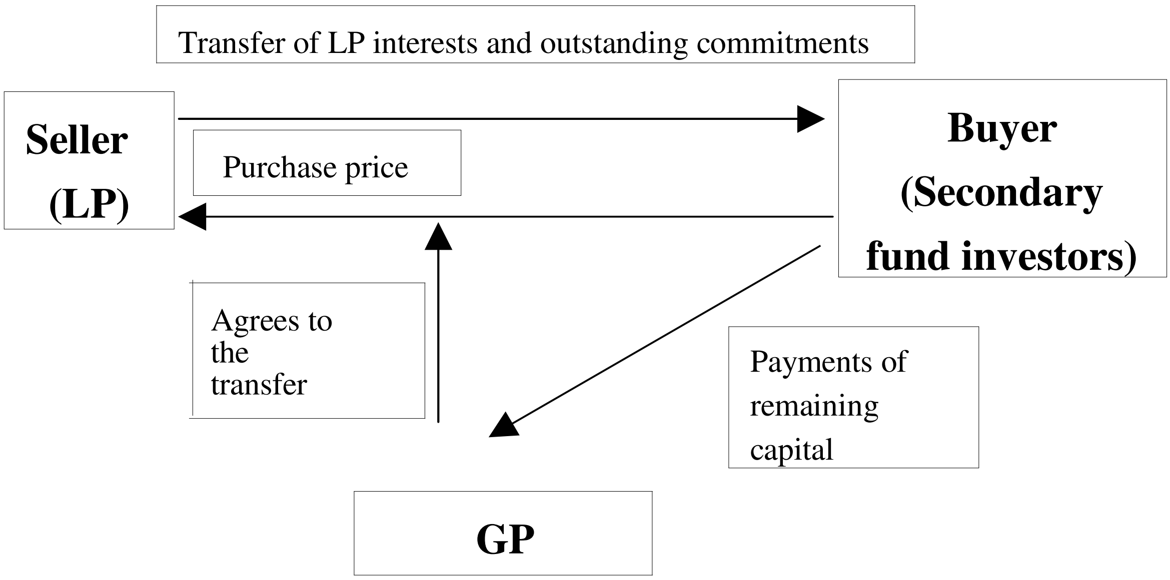

Figure 4. A typical private equity secondary transaction

[8] NYPPE Private Partnership professional

5.2 Buy-side incentives

Secondary fund investors, which purchase investors' interests in illiquid private equity funds, generally seek to buy "good assets cheaply" from sellers forced by circumstance to sell assets that they would otherwise prefer to hold. To the buy-side, the secondary funds provide a number of inherent investment advantages:

A muted J-curve

The so-called J-curve is usually depicted by plotting the net cash flow generated by a private equity fund against time (from inception to termination). Private equity funds usually show negative returns in the early years of fund life because of the management fees and other expenses. But as the fund approaches maturity, values increase to bring a positive sign.[9] Secondary investments often show a muted J-curve, because it is usually transacted as a discount to the General Partner's reported value, leading to an immediate accounting gain and high IRR. Secondary investments also exhibit a muted J-curve due to the early return of capital and time advantage of buying into a fund later in its investment cycle. Purchasing a fund that is several years old allows the acquirer to avoid the fund's early write-offs and expenses, including management fees, which tend to produce negative returns during the fund's initial years. The complementation of primary and secondary funds provides a balanced return curve to investors.

[9] 2004 Private Equity International, www.privateequityinternational.com

Avoid Blind Pool investment risk (asset transparency)

The primary investors have no real ideas of the future assets in the portfolio and hence expected returns. What they can study is only fund managers' skills and former track records of sourcing, implementing and exiting. An industry saying is 'Investing in secondary private equity is like betting on a horse that is already halfway around the track.' Investing in private equity on a secondary basis means "perfect" hindsight of assets quality and valuation since the fund is under halfway operation and the actual performance is easier to be observed.

Enhanced diversification

The combination of the secondary with primary private equity exposes the investors to a larger variety of industries, more diversified vintage years, more extensive geographies, fund sponsors and investment strategies.[10]

Discounted price

A typical secondary purchase price is discounted between 20 % and 70 %.[11] The secondary purchaser has the chance to assume a position in the underlying assets at a price well below the valuations that may have been paid at the height of the market and earn rates of return higher than those achieved by the LPs of the primary investments.

Fund control

The General Partners of private equity funds typically have longstanding relations with their limited partners and add very few new limited partners with each successive fund; the secondary purchasers open a channel of communication with partners to better understand their strategies and preferences through attendance at annual meetings which can often gain an inside track to participating in future funds.

Historic returns

Among any investment opportunity, returns are what really drive investors' attention. From June, 1999 to June, 2002, the average annual return for secondary

[10] Optimizing Private Equity Portfolios with Secondary Transactions, Venture Capital 2003
[11] NYPPE Private Partnership professional, www.nyppe.com

private equity was 27% (Greenwich Research Group) versus –22.3% for primary venture capital (Venture Economics) and –7.5% for the S&P 500 (Venture Economics). In addition, the standard deviation of annual returns between primary venture capital and secondary is nearly 3 times higher for the secondaries according to Greenwich Research Group during 1970 to 2000.[12] In this context it could be useful to apply the Sharpe ratio i.e. ROI/SD. It thus follows from the above observations that the Sharpe ratio, ceteris paribus, would be lower for secondaries than for primaries because of the higher standard deviation of the secondaries. However, due to the fact that the ROI of the secondaries can be considerably higher than the corresponding ROI for primaries, the comparison of the Sharpe ratios between primaries and secondaries can not be generalized.

Typical example of buyer's perspective

The graph on the next page shows a typical buyer's perspective based on a fixed value commitment of 100 which means that the fund owners have committed to an accumulated payment of 100, usually to be paid in upon capital calls by the General Partner. In this example the net incremental cash flow (not shown in the graph) is negative up until and including year 4 but then turns positive after year 5. In this case the most attractive acquisition period begins in year 4 and continues through year 10 depending on the discount to NAV (Net Asset Value.)[13]

[12] NYPPE Private Partnership Professional

[13] Brian Mooney, "Timing Secondary Transactions", 2003, Cogent Partners

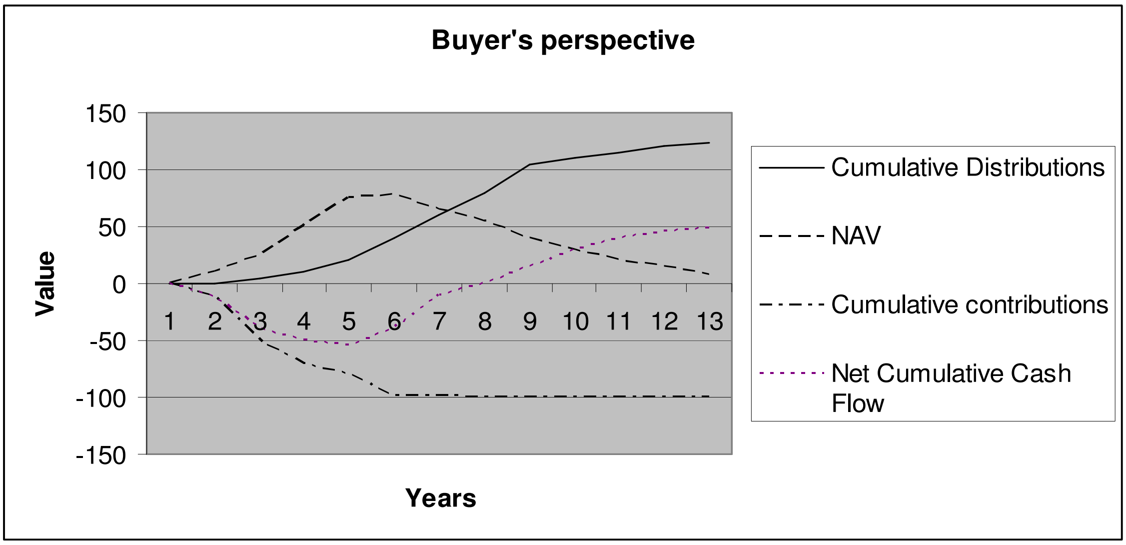

Figure 5. A typical buyer's perspective where the ideal time to buy would be after 4 but before 10 years. Note that Net Cumulative Cash Flow constitutes the difference between Cumulative Distributions and Cumulative Contributions. NAV represents Net Asset Value taken from the balance sheet. After year 4 the yearly contributions quickly approaches zero (in year 6) whereas at the same time the increase starts in the yearly distributions. After year 10 the yearly distributions flatten out almost to zero.

5.3 Sell-side incentives

During the 10-year plus life of a private equity fund, the circumstances of investors and limited partners may change. For an investor, changes in asset allocation, cash flow needs, management, ownership, strategy, and the regulatory environment, can result in a need for early liquidity. Divesting of an entire portfolio is often a more effective and manageable way to dispose of large investments than by following through on a series of single exit processes. To the sell-side, the secondary funds provide a further number of advantages:

Reallocations

To meet new, more stringent capital reserve requirements or when facing financial difficulties, many LPs have to re-deploy capital into more strategic fund relations, and reallocate their commitments in private equity via secondary direct.[14]

[14] Paul Capital Partners, www.paulcap.com

Meeting needs for liquidity

Many Limited Partners may have insufficient cash to meet their remaining draw down commitments and they are afraid to have their paid-in capital forfeited by GPs, so a secondary transaction becomes a fantastic alternative pathway to liquidity.

Reduced administrative burden

Sometimes managing too many partnership interests will lower the quality of the investment. Correcting an over-allocation or over-commitment to the private equity asset class makes it easier for sellers to focus more on the key profitable section.

Typical example of seller's perspective

The graph below shows a typical seller's perspective based on a fixed value commitment of 100. The 'total value created' line in figure 5 is the sum of the NAV (Net Asset Value) and cumulative distributions. As can be seen from the 'total value created' line, the majority of the value creation in the portfolio has accrued to the benefit of the seller after about 7 years. Consequently, in this case a recommendation to sellers would be to consider sales of their partnerships after about seven years.[15]

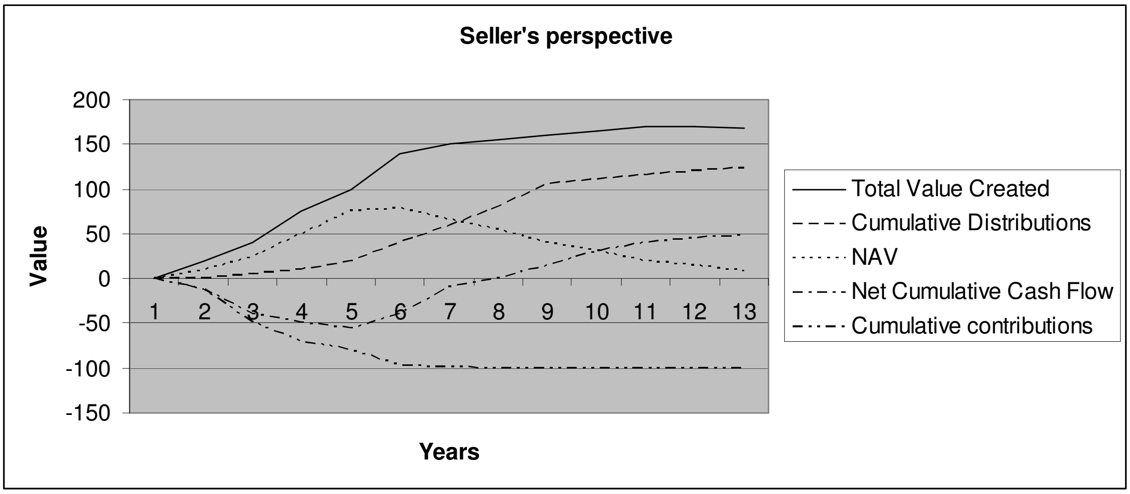

Figure 6. A typical seller's perspective where the ideal time to sell would be years 7-11 when the Net Cumulative Cash flow has turned positive but not yet flattened out. This will also give the seller his best arguments when convincing the buyer about the project's future value.

5.4 International key actors

Most key actors within secondary private equity are US or UK-based. Key actors include specialized private equity advisory boutiques and to a degree investment banks. Some of the leading secondary investors are Coller Capital, Lexington, LGT and Harbourvest, where Lexington independently manages five secondary funds with $4.6 billion in committed capital (the "Lexington Funds"), co-manages six secondary funds with committed capital of $1.2 billion, and claims to

[15] Brian Mooney, "Timing Secondary Transactions", 2003, Cogent Partners

be the “leading independent manager of secondary private equity funds”.[16]

5.5 Secondary private equity market activities in Sweden

The secondary private equity market is now being established in Sweden. Until recently, there have been no dedicated secondary private equity investors in Sweden like the ones mentioned before in the US and UK. However, several one-off secondary fund transactions have been performed. We have studied cases of secondary private equity transactions in Sweden and these findings and interviews are reported in our research as case studies, see below.

The Norwegian Four Seasons Venture A/S has successfully finalized the capitalization of its fifth fund with the dedicated focus on buying secondary portfolios. At the same time their management partner Four Seasons Management is establishing a new office in Stockholm. This will be the first private equity company in Sweden with a dedicated focus on secondary private equity. The fund has raised 1 billion SEK and has invested in a portfolio of 19 unlisted companies from Skandia Liv, see case study # 1. Recently, in June 2006, Four Seasons Venture A/S made their second portfolio acquisition in Sweden when buying 14 private equity companies from Aggregate Media AB. The investment profile of Four Seasons Venture A/S will be companies having each a turnover of twenty up to a few hundred MSEK and they aim at equity participation between 15 and 49 percent plus a seat with the board of directors. Major investors in Four Seasons Venture A/S are Argentum (a risk capital fund owned by the Norwegian Government), Tredje AP-fonden in Sweden and the Swedish trade union SIF.[17]

We have further studied the latest directory of 2005-2006 from the Swedish Private Equity and Venture Capital Association in search of a description or comment on secondary private equity activities in Sweden.[18] However, this book contains no reference at all to this type of activity.

[16] Press release by Lexington Partners July 14th 2003 and www.lexingtonpartners.com

[17] Dagens Industri 2005-11-02, p 9, ”Norskt riskkapital till Sverige”

[18] Directory 2005-2006 Swedish Private Equity and Venture Capital Association

6. VALUATION AND TRANSACTION TECHNIQUES

6.1 Basic valuation factors

Since private equity limited partnerships by definition are not market-to-market on any regular basis, the valuation policies of general partners vary tremendously, involving the assessment of tangible and intangible factors.

Tangible valuation factors

- The basic information to derive a reasonable valuation is the current status of the companies in the invested portfolios. But many GPs hold investments at cost until a significant valuation event occurs, so the reported valuation from the GPs may not reflect real situations.[19]
- Access to more information can provide a better knowledge about the reported valuations from GPs since under most partnership agreements a General Partner is not obligated to provide extra info. Any investors with an established relation with GPs may enjoy the advantage of more source of information.
- As a secondary purchaser, it has no right to renegotiate the underlying documents. So some unusual articles in the financial terms and conditions may affect the valuation of the investments.
- A traditional valuation is mostly based on the underlying assets being purchased, while a secondary purchase is obligated to assume all future funding commitment of a position being sold as well. The amounts of undrawn capital commitments can greatly affect the valuation results.

Intangible valuation factors

The reputation of the GP can greatly affect valuation sometimes, especially when there is a large amount of undrawn capital in the fund being purchased. In some other cases, a secondary purchase may give an investor an entry into a previously inaccessible fund and its successors. Thus the potential buyers seek access to future funds raised by this GP and may be willing to pay a premium for establishing a

[19] Secondary Activity in Private Equity Investing, Probitas Partners

formal relation with the GP.[20]

6.2 Other valuation issues

Normally, buyers make their valuations based on two components: the current portfolio and the un-funded commitments.[21] The first step to get a rough value of the current portfolio is to model returns, to estimate the exit value of an investment and the timing until liquidity for each investment. Many secondary investors have historic cash flow characteristics of a large number of funds and they will discount the presumed future cash flow at a reasonable rate to get a rough valuation.

As a rough proxy for the fair market value, a buyer can consider the performance of a basket of public market comparables for each portfolio investment. Care must be taken to consider the appropriate comparables and adjust for any unique circumstances. As to the un-funded portion, a long track record and history of superior returns would likely result in an easy fund raise for the GPs. The more difficult the fund raise would be, the higher the discount is needed to place the un-funded commitment.

During the process, non-figure measurement as a venture capitalist can also be contributory to the final valuation, such as how strong is the management team, how attractive is the business model, what progress has been made and what future dilution can I expect to encounter.

There are always some other factors popping out that will affect the pricing. A similar work will be done to assess a $10 M acquisition as a $100M. The opportunity cost of working on a smaller commitment results in a larger discount. If a seller is in a hurry to get liquidation, then he may pay more attention to the speed of the transaction instead of the pricing. To the buyer, a short and quick assessment may have the risk of a less proper valuation, but a larger discount is always a way out to compensate this.

[20] Secondary Activity in Private Equity Investing, Probitas Partners
[21] Colin McGrady, Cogent Partners 2002

6.3 Transaction steps

There are several important steps to be considered when a secondary direct transaction is implemented.

- Search and screening
- Initial evaluation including qualification check i.e. buyers' check if the target fund meets their investment criteria
- Non Disclosure Agreement (NDA) signed with sellers, maintaining a.o. price and other sensitive information as confidential
- Negotiations on terms and conditions
- Preliminary agreement on price and main conditions
- Due diligence process (see Appendix)
- Final negotiations based on findings in the due diligence process
- A firm sale and purchase agreement is signed
- Closing (typically 3-6 months after initial evaluation)

Most of the above mentioned steps are self-explanatory, but the due diligence process needs some further elaboration. We have listed in our Appendix the major headlines of a due diligence investigation. A common structure of the due diligence process involves a legal review as well as a financial review. In some cases it may also be necessary to include in the due diligence process specific reviews of other issues such as e.g. technical issues or environmental issues. As can be seen from our Appendix 10.8, most of the issues listed will be handled by legal and financial advisors.

6.4 Some other important issues

Heavy discounts to a General Partner's reported Net Asset Value

Most often, sales of private equity funds are driven by internal motivations instead of the quality of the portfolio. Discounts to NAV can be very high (more than 70 %), especially in the period after the year 2000 in the bear market that followed for venture capital funds.

Increasing competition in the secondary private equity market

Given all the benefits of investing in the secondary, it becomes more and more popular and raises maybe too much capital, which will put pressure on profits. Greater competition among secondary investors will increase the valuation of the same assets, which will counteract secondary returns.

Earlier investment in secondary direct market

According to data from Lexington Partners, the weighted average age of partnerships sold between 1990 and 2002 was 6 years, but in 2002, the corresponding figure was 4.8. Secondary direct enjoyed accelerated cash returns and more liquid assets than primary private equity because it purchased LP interest usually in the rising part of the J-curve. The trend now is that they start to purchase young LP interest, with some as young as three years old and 50% funded. This makes the investment riskier than before and may influence the returns of the secondary direct.[22]

Time consuming transfer process

Once an agreement on financial terms of a purchase is reached, the transferring position process can be long and protracted depending on the complexity and size of the portfolio. Each transaction usually requires the approval of the GPs. In some cases complex structures may be required for legal, tax and accounting reasons. They may involve sharing of assets and proceeds, contingent future payments, creation of a new structure to hold the assets and insertion of a team to manage the assets.

Limited market for single, small positions

The attentions of secondary direct have shifted to larger portfolio purchases, so there are usually less interests in bidding on smaller, single positions.

The confidentiality conflict

GPs usually regard sales of an interest in their fund as a negative signal to other investors and try to limit the sales information within related parties. LPs usually prefer to spread the selling notice to as many potential buyers as possible to get a higher price.[23]

---

[22] Brian Mooney, Timing secondary transactions, Cogent Partners 2003

[23] David W. Tegeler, Kristin S. Caplice, Secondary Considerations: An introduction to Secondary Funds

The danger of auctions

As to the increasing use of auctions to find the proper potential buyers, especially in the large transactions over 100 million dollars, Winner's Curse problem is hard to avoid, i.e., the highest bidder overpays for the asset because he or she has overestimated the value of the asset more than any one else.[24]

No attribution of value to a well-constructed portfolio

Deep discount becomes the biggest attraction, which overcomes all other benefits and considerations, so that nearly none of the buyers are willing to attribute value to the investment program of the selling entity.

Future trends in secondary private equity

It is likely that large secondary direct fund managers will face a more competitive market and will find it more challenging to invest the significant capital they have raised over the past several years.[25]

- The trend of decline after the year 2000 for fund-raising in the primary market.
- Alternative sources of secondary activity (primary secondary, total return swap, asset backed securitizations, secondary directs, etc.)[26]

---

[24] Alex Sao-Wei Lee, Private Equity Secondary Funds and Their Competitive Strategies
[25] Secondary Activity in Private Equity Investing (Liquidity for and Illiquid Assets), Probitas Partners
[26] Ibid

7. RESULTS FROM CASE STUDIES

We have concentrated most of our case studies to Sweden in order to understand how secondary private equity activities have entered into the Swedish financial markets. Our final case interview was conducted with Cogent Partners in London, an advisor on secondaries with a global perspective.

7.1 Four Seasons Venture A/S and 3i buy The Prosper Fund from Skandia Liv

Our first example of a secondary private equity portfolio transaction is the divestment of Skandia Liv's Prosper Fund portfolio which we have chosen as our case study # 1. Except for its holding in Boxer AB, the rest of the Prosper Fund portfolio of 19 holdings was acquired by the Norwegian Four Seasons Venture A/S Fund V, managed by Four Seasons management, with whom we also managed to get an interview. At the end of our study we also managed to get an interview with Skandia Liv.

Results: This transaction is a good example of the difficulties for a big institution like Skandia Liv (a pension fund) to manage a portfolio of holdings in small companies during a sharp market down-turn. This case study was also of special interest as the acquirer, Four Seasons Management, will be the first private equity fund manager to establish itself in Sweden with an explicit focus on investments in secondary private equity direct fund portfolios. The Prosper Fund was their first step. In this transaction intermediaries had important roles to play, including the initializing of the sales process, but there were no institution acting as a broker, similar to NYPPE.

In our third interview, Skandia Liv explained the reasons for their divestment of the Prosper portfolio to be due to the strategy shift after the extreme downturn following 2000. Skandia Liv then made a strategic decision to leave direct private equity investments in favor of investing indirectly through funds, or funds of funds, managed by other private equity actors. Skandia Liv does not believe that secondary private equity portfolio activities will represent a substantial growth market in Sweden in the near or medium-term future. Neither do they believe that there over the foreseeable future will be established an institutionalized market exchange for secondary private equity portfolio market in Sweden. Finally we learned that Skandia Liv is not planning to structure any future private equity activity into portfolios to be tradable as secondaries. It is important to note that although Skandia Liv strongly believes in private equity as a value-creating asset class they recognize that due to the heavy demands on investment manager manpower Skandia Liv should not engage directly in this asset class in the future.

7.2 The creation of the new Småföretagsinvest based on the old Aldano

In our second case study we researched the secondary private equity portfolio transactions taking place in creation of the new Småföretagsinvest AB, which today is a typical secondary private equity structure after having initially started as a blind pool (i.e. new capital is raised into a fund where there initially are no investments) open-ended investment fund. Along its development there have been two major acquisitions of private equity portfolios. First Aldano and Småföretagsinvest merged and later Småföretagsinvest merged with Arbustum, involving in total about 30 different companies. We have studied and interviewed Småföretagsinvest, please see case interviews 2.1, 2.2 and 2.3.

Results: In these deals we also found good illustrations of the difficulties for big institutions like pension funds or banks to manage by themselves private equity portfolios of small companies. After the sharp market down-turn in 2001 these holdings lost much value and the exit decision opened up for a secondary private equity portfolio transaction. Here valuations were performed in a structured way but no intermediate institution (similar to e.g. NYPPE) served as a market place for the deal. During our interview with Bo Thorsson, MD of Småföretagsinvest and an established expert on private equity in Sweden, we noted his opinion that secondaries over time will be established in Sweden following a development which is rather similar to what has evolved in the big Anglo-Saxon countries. The time-line could be rather long, however.

7.3 Ledstiernan buys Speed Ventures

Our third case study is Ledstiernan's acquisition of Speed Ventures.

Results: In this transaction we found that bidders reported a lack of structured analysis of valuations regarding the portfolio companies. In this special case it seems that the cash position of Speed Ventures was the major factor in the valuation analysis of the buyer.

7.4 Other Swedish transactions involving secondary private equity portfolios

In our case study # 4 we report the results from our research of press releases by ten Swedish private equity companies since 1999.

Results: We found half a dozen secondary private equity portfolio transactions having been reported by these ten companies during these seven years. The transactions are about evenly spread over time after 2001 and all of them are secondary direct, i.e. all shares in a private equity fund are acquired by an investor who thereby becomes a "direct" owner in all the portfolio companies. We could find no example of a secondary non-direct transaction in these press releases.

7.5 Cogent Partners

Our fifth case study focuses on Cogent Partners which is a private equity focused investment bank mainly operating in the US and UK, and dedicated to serving the needs of the private equity community. Cogent Partners represents sellers in traditional and securitized secondary transactions, conducts detailed portfolio assessment and pricing analysis, and provides fairness assessments for secondary buyers and sellers. Cogent Partners has a global perspective and underlines the time lag between the development of the secondaries markets in the US and Europe respectively. The development of secondaries is closely related to the development of primaries.

Results: Cogent Partners sees Sweden as an early adopter both in primary activities as well as secondaries and believes in good growth opportunity for secondaries in Europe as a whole and not the least in Sweden. However, the market for secondaries will have its bumps up and down and one will be able to relate them to similar bumps in the primaries market development. Cogent Partners does not believe at all in the establishment of an institutionalized market exchange (similar to NYPPE) in Europe including Sweden. Cogent Partners believes NYPPE to be a relatively insignificant institution in comparison to the deal volumes going beside this institution.

7.6 Details

All details of our five case studies and eight interviews are to be found in the appendices, section 11.

8. CONCLUSIONS AND DISCUSSION

From our studies of the international literature and from our case studies in Sweden and London we have drawn the following conclusions in relation to our objectives:

8.1 Objective 1: *To understand the status and indicate some future development trends for the secondary private equity portfolio market in Sweden and to observe possible differences compared to the recent dynamic developments in the US.*

In Sweden the term secondary private equity is not yet well-established but nevertheless such transactions are already taking place also in our market. As we have found internationally, and particularly in the US, secondary transactions involving Limited Partnership stakes have taken place for the last twenty years, growing rapidly in frequency and volume over the last ten years. This is not the case in Sweden where the deals that we have found rather have their background from the dramatic negative changes in valuations following the recent 2000-hype.

Furthermore, in more developed financial markets, e.g. in the US, secondary private equity investments are privately as well as publicly held. In Sweden there is presently no example of a listed company with the dedicated business idea to engage in the secondary private equity market. In all the examples of secondary private equity transactions that we have found in Sweden the buyers have been unlisted companies.

Consequently these recent Swedish secondary private equity transactions might be more of an extraordinary occurrence than the initiation of a mature market. However, examples such as the Four Seasons Venture, the comments from Cogent Partners and

Bo Thorsson show that this conclusion might be only temporarily correct. It is thus our belief that also the Swedish market over time may develop some sort of a secondary private equity portfolio market, but that this time factor could be rather long.

8.2 Objective 2*: To study whether an exchange similar to NYPPE can be expected to be established also in Sweden*

According to Cogent Partners, there are no traces of something similar to the NYPPE institutionalized market exchange being developed here in Sweden. At the same time we have found a great degree of secrecy around the issues of valuation in respect of secondary private equity transactions that we have studied. Buyers tend to identify one or two top companies in the offered portfolios and valuation as well as due diligence work is focused on these. The rest of the offered portfolios seems to be given only marginal value and attendance in the due diligence process. If substantial cash is available in the target fund then this of course will become a factor of valuation in its own right and may even overshadow the values of the individual portfolio companies. It seems obvious that the sellers would benefit from an institutionalized market exchange also here in Sweden. Probably also the buyers would experience benefits from a greater supply of deals although margins might go down. However, we have found no support for the theory that such a market exchange in Sweden is underway or even envisaged to be developed in the foreseeable future.

8.3 *Objective 3: To discuss whether Swedish private equity companies in the future are likely to structure their portfolios in such a way that they will be tradable as portfolios of secondaries.*

It is significant for the non-mature Swedish secondary private equity market that many private equity companies have portfolios which could be traded as secondary funds but are not yet. Instead the private equity companies exit their portfolios company by company. If Swedish private equity companies would experiment with building up portfolios for sale as secondaries then this would drive the development of the secondary private equity market niche. Also, in Sweden no financial advisor has his/her activity dedicated to secondary private equity. Most Swedish financial advisors are still focused on single-company transactions. It is our belief that over time, this will probably also change and a few advisors will specialize towards secondary private equity transactions. Taking into account our findings with Four

Seasons Venture we conclude that also some Swedish private equity companies in the future will structure their funds to be tradable as portfolios of secondaries.

8.4 *Objective 4: To study the valuation process involved in the secondary private equity portfolio price assessments in Sweden.*

We have found that in the secondary private equity transactions in Sweden, the valuation process is not standardized and varies very much depending on the individual cases. The methods most commonly applied are DCF, NAV, P/E, market comparable analysis and composite match analysis. We believe that with the maturing of the secondary privat equity market in Sweden, there will develop a more standardized methodology in the valuation process.

8.5 Which of the incentives where applicable?

In section 5 we listed buy-side incentives as well as sell-side incentives as we have found them in theory. When comparing the results from our interviews we can draw some conclusions:

Buy-side

- The diversification incentive is well confirmed in our interviews.
- Similarly, the discounted price incentive is an important driver and this incentive is of course closely related with the "muted J-curve" incentive which we also feel that our study confirms.
- The "avoid blind pool" incentive is not visible to us in our interviews because our interview targets have been focused on the secondary aspect.

Sell-side

- The reallocation incentive has been visible in most of our interviews.
- Similarly the "reduced administrative burden" incentive is also present.
- The "need for liquidity" drive was not as prevalent as we had expected; this might be due to our choice of interviewees on the sell-side who practically all of them were well capitalized.

8.6 The future of private equity secondaries in Sweden

A general conclusion from our study is that we believe that the secondary private equity market in Sweden will over time develop into a more mature stage. As a comparison we observe that the venture capital market in Sweden started about 30-40 years after their counterparts in the US and the UK and have only now after more than 20 years reached an established situation. We believe that the increased activities in Sweden within secondary private equity portfolio transactions during the last 4 – 5 years are mainly due to the aftermath of the 2000-hype in primaries, when many owners after the market downfalls wanted to leave their direct ownership in private equities. They were also prompted to such decisions by the almost complete drying up of the market for IPOs. With no exit alternative through IPOs then the owners of primaries started to use private exits and this substantially pushed the market for secondaries. Today the IPO market has returned – although with different requirements – and this has taken away one argument for the secondaries. However, the market for secondary private equity portfolio transactions will continue to develop also in Sweden, but may need several more years in order to mature.

9. SUGGESTIONS FOR FURTHER RESEARCH

One conclusion from our work is that we find signals that the Anglo-Saxon development of markets for secondary funds transactions will evolve also in Sweden. Another conclusion is that very little has yet been documented in Sweden about this type of market, why our research probably stands out as one of the first studies.

We would encourage a repeat study in a few years' time, again focusing on the general situation in Sweden regarding the existence of secondary private equity portfolio transactions. Such a study could yield a possibility of an interesting comparison to the present situation which we have tried to picture in our research. We suggest that special considerations should then be given to the analysis of which different drivers that have prompted the market actors.

Another study could focus on the valuation techniques applied today by international secondary direct investors. Our research has pointed to the DCF and NAV valuation techniques but also indicated that there are other alternatives. A professional investor in secondary direct private equity will probably use a toolbox of different valuation methods and this could be an interesting field of further research.

A third study could compare the US situation with that of Europe. From our interview with Cogent Partners in London we concluded that the European development of secondaries is trailing what has developed in the US. However, both similarities and differences exist and they could be the topics of further research.

10. REFERENCES

Printed references

Beinkampen, Karl, ”Special situations: The evaluation of nontraditional private equity strategies”, Morgan Stanley, March 2005

Columbia Strategy, “What Private Equity Firms Need to Know About Secondaries”, 2005

Dagens Industri 2005-11-02, page 9, ”Norskt riskkapital till Sverige”

Daniels, Holger von, “Private Equity Secondary Transactions”, 2004, DUVGabler Edition Wissenschaft

DePonte, Kelly, “Secondary Activity in Private Equity Investing (Liquidity for an Illiquid Asset)”, Probitas Partners

McGrady, Colin, “The advantages of purchasing secondaries”, Cogent Partners 2002

Mooney, Brian, “Timing secondary transactions”, Cogent Partners 2003

Paul Capital Partners, Optimizing Private Equity Portfolios with Secondary Transactions, Venture Capital Journal 2003

Pratt, Mary K, “More enter private equity field via secondary funds”, Boston Business Journal, February 20, 2004.

Sao-Wei Lee, Alex, “Private Equity Secondary Funds and Their Competitive Strategies”

Soulignac, Charles, “How to select secondary funds”, Fondinvest Capital

Spangler, Timothy, “A Practitioner’s Guide to Alternative Investment”, 2005

Swedish Private Equity and Venture Capital Association, Directory 2005-2006

Tegeler, David W, Caplice, Kristin S., “Secondary Considerations: An Introduction to Secondary Funds”

Testa, Hurwitz and Thibeault, “Secondary considerations, an introduction to secondary funds”, 2002

Vaughn, Hopa, “Secondary Private Equity Funds: The Perfect Storm, An Opportunity in Adversity, 2003

Internet references

3i Nordic, www.3i.com/sweden/media/pressrelease

Sjätte AP-fonden, www.apfond6.se

Affärsstrategerna, www.astrateg.se

Alpinvest, www.alpinvest.com

AXA Private Equity, www.axaprivateequity.com

Capman, www.capman.se

Coller Capital, www.collercapital.com

EQT, www.eqt.se

HarbourVest, www.harbourvest.com

Industrikapital, www.industrikapital.com

Lexington Partners, www.lexingtonpartners.com

Nordic Capital, www.nordiccapital.com

NYPPE, www.nyppe.com

Permira, www.permira.com

Private Equity International, www.privateequityinternational.com

Procuritas, www.procuritas.se

Ratos, www.ratos.se

SVCA, www.svca.se

11. APPENDICES

Case study 1: Four Seasons Venture A/S and 3i buy the Prosper Fund from Skandia Liv

Interview 1.1: Q&A with Stefan B Andersson at C4 Partners which acted as financial advisor to 3i during the sale of Skandia Liv's Prosper Fund.

1. Describe C4 Partners and its main activities.

C4 is a focused secondary fund expert. They are not bankers but originally media entrepreneurs consisting of people from the media market. They have been financial advisors to a numbers of buyers, e.g. Barclay's Bank, 3i, etc.

a) As a first step C4 Partners perform market analysis trying to find undervalued companies in the TIME (Telecom, Information technology, Media and Entertainment) sector, in this case the Prosper Fund portfolio, to induce new deals between buyers and sellers. C4 partners are especially good at telecom and information technology.

b) As a second step C4 Partners try to convince the sellers or potential buyers with their analysis and valuation, offering the services of C4 Partners as their sell side or buy side advisor of the transaction.

c) The third step is the sales phase when they have been contracted to act as advisors, e.g. when C4 Partners acted as buy side advisors to 3i in their acquisition of the Boxer company through acquiring the Prosper fund from Skandia Liv and then re-selling all but one of the companies.

2. How did you get involved in the Prosper fund transaction?

The starting point was when C4 did research regarding the Boxer company, finding that its potential value probably was much higher than the present assessment by its owners which consisted of Teracom 70% and Skandia Liv 30%. C4 Partners first contacted Teracom in the hope of making their shares available for a transaction. Having failed there, they then contacted Skandia Liv where they got the information that Skandia was trying to divest the Prosper fund composed of 20 companies including the shares in Boxer.

3. Can you describe the divesting process?

It became an auction market which started with an investment memorandum drawn up by the seller, Skandia Liv, and its financial advisors. The auction eventually resulting in a final bid acceptable to the seller whereupon signing and closing took place. It should be noted that due to the fact that 3i was only interested in the Boxer company, 3i arranged for the divesting of all of the other company shares in the Prosper fund portfolio to a final buyer: Four Seasons Venture V, managed by Four Seasons management, based in Oslo, Norway, but now establishing themselves through this acquisition in Sweden and opening an office in Stockholm.

4. Which other financial advisors – if any – were involved?

Handelsbanken Securities were the financial advisors of the sellers. Some buyers had financial advisors and some did not. The auction market method was used to complete the first round process (preliminary bid.)

5. What functions did Skandia Liv have during the selling process and what functions did the financial advisors have?

The information memorandum was distributed to about 15 potential buyers with basic data about the Prosper fund and the planning as well as the timeline for the process of divesting it. Then the auction market process eliminated 11-12 buyers and the rest were invited to a second round. They got access to a database room where much more detailed data about the Prosper fund portfolio companies was available. Subsequently, these 3-4 interested potential buyers handed in their final bids, based upon much more precise valuations. Out of these bids Skandia Liv picked one for signing. The buyer turned out to be 3i, which retained C4 Partners as their financial advisor. After signing, 3i together with C4 Partners started a due diligence process which was later followed by a closing of the transaction.

6. How was the list of buyer candidates made up?

The list of buyer candidates was researched, screened and contacted by Skandia Liv's financial advisor Handelsbanken Securities. C4 Partners as advisor to one of the buyer candidates, 3i, of course had neither influence nor insight into this activity.

7. How many buyer candidates were there on the list?

There were 10-15 buyer candidates as far as C4 Partners knew.

8. How long time did the selling process take?

The selling process took much longer time than originally planned by the seller. Initially Skandia Liv planned to handle the divesting transaction by itself and without a financial advisor. Their target for closing was then November 2004. However, Skandia Liv soon realized that they required a professional financial advisor and then Handelsbanken Securities involved in the process about 2 months later. The total transaction was then done within a timeline of an additional 7 months.

9. Can you give us any comments on the aspects of valuation?

From C4 Partners' perspective we can of course only comment upon the valuation principles and procedures from the final buyer, 3i, as C4 Partners were their advisor. 3i and C4 Partners applied two principles. The first principle consisted of a DCF (Discounted Cash Flow) valuation. The DCF method means that we project the cash flow from future earnings of the Prosper fund portfolio and discount these cash flow numbers back to present value. The second principle applied the market comparables method which means that research was made for companies similar to those in the Prosper fund portfolio. Provided that there had been transactions for such companies then there would also be a guiding valuation applicable to the corresponding Prosper fund portfolio company.

10. Any other relevant comments on the deal?

Not many theories and methods which we have learned from school were applied during the transaction. Most of the work done depends on long term working experience, intelligence (brain tank), intuition and competence in this business since lack of information is such a common phenomenon. C4 gave us a very good example. They did another transaction earlier with Nordea Capital about the acquisition of Canal + where Nordea Capital thought that they had all of the required information but in the views of the C4 advisors they actually had substantial shortcomings which negatively influenced their deal.

Interview 1.2: Four Seasons Venture establishes Stockholm office focused on secondary direct activities, Q&A with Peter Gullander, partner, FSV.

1. Please describe FSV and its business idea.

Four Seasons Management AS ("FSV") is a Norwegian venture capital advisor advising funds totaling SEK 3 billion. FSV today has offices in Norway and Sweden. FSV invests in the primary venture capital market as well as in the secondary direct market where entire portfolios of direct investments are acquired. In both markets FSV aims via active ownership to build top companies.

2. Please describe FSV's activities in Sweden.

Through our acquisition last year of the holdings and management rights in Skandia previously managed by Prosper Capital, we have established 19 holdings in Sweden. We are also looking at new investment opportunities with a focus on portfolio acquisitions.

3. Why did FSV decide to acquire the holdings managed by Prosper Capital?

We were contacted by a well-known international secondary fund that needed a local management team. What differs from traditional fund management is that in this case we acquired the entire portfolio.

4. Can you describe the investment process?

Portfolio acquisition is a different process compared to the investment done by a traditional venture capital firm. We have experienced one such previous portfolio investment in Norway in 2003 with 96 assets.

5. Were there any external financial advisors involved on your side in this transaction?

Yes, we used one external advisor, a smaller investment bank together with whom we refined a previously built financial model in order to be able to evaluate the 19 assets quickly.

6. Can you give us any comments on the aspects of valuation?

The purchase price was confidential. But the principle was the following: First we made a basic rough estimate of the value in the various holdings, and then divided the assets into 3 categories: Tier 3 (Least valuable holdings), Tier 2 (Medium in terms of value) and Tier 1 (Most valuable holdings). We then focused on the top companies and performed valuations and more detailed due diligence on these.

7. Can you please comment upon the development of this portfolio after its acquisition?

- Have you divested any companies from the original portfolio?

Yes, we have exited one of the assets so far.

- Have you made any add-on acquisitions to the portfolio companies?

No, not yet. We have the ability to quickly do add-on investments, as we have a fund with dedicated capital to do portfolio acquisitions already in place.

- Are there any top companies which merit special comments?

Yes, as in all portfolios, but it is still too early to say if our analysis was correct.

- Are there any lemons?

Yes, of course, as in all portfolios. We do not have any bankruptcies so far but we have certainly encountered negative surprises.

8. Any other relevant comments on the Prosper transaction?

The Prosper transaction was closed in July 2005. A small number of companies in a portfolio like this will represent the major portion of its value. Our Swedish portfolio is large enough to represent a well-diversified risk profile.

9. What are your thoughts on the secondary private equity market in Sweden and Norway?

The market is beginning to get sufficiently mature to motivate the establishment of local secondary direct players in the Nordic market. At present, we do not know of any other investor in the Nordic region which has a dedicated focus on the secondary direct opportunity.

10. What will be the role of FSV in this market?

Our recent Swedish fundraising now totals 1050 MSEK where a little less than half is still available for new investments. We are focusing actively on the secondary direct market, allowing for an alternative exit possibility to VC fund managers and fund Limited Partners. We estimate that in the world there has been some 28-30 transactions of a secondary direct character performed that are visible and non confidential.

Interview 1.3: Skandia Liv, Q&A with Niclas Ekestubbe, Portfolio Manager Private Equity, Skandia Liv.

1. Please describe Skandia Liv and its main activities.

Skandia Liv is Sweden's largest pension company managing total assets amounting to SEK 280 bn whereof SEK 5 bn represent private equity.

2. Can you describe the divesting process of the Prosper Fund? Why did Skandia Liv decide to exit the Prosper Fund? Were there any financial advisors involved?

Skandia Liv invested in a number of privately held companies during 1998-2000 when valuations for such investments where increasing year by year. After the heavy downturn following 2000 Skandia Liv made a strategic decision to leave direct private equity investments in favor of indirect Private Equity investing, i.e. through funds or funds of funds. Handelsbanken served as financial advisor to Skandia Liv in the divesting process of the Prosper Fund. The main reason for Skandia Liv to leave direct private equity investments was the recognition of the substantial investment management resources required to handle such portfolios.

3. Can you give us any comments on the aspects of valuation?

We used the DCF principle together with relevant peer group valuations, however, one must always remember that the DCF technique certainly is very difficult to apply for companies in early stages, if at all relevant.

4. Any other relevant comments on this deal?

This was a rather special transaction because it involved three parties: the seller and two independent buyers, 3i and FSV respectively.

5. Will Skandia Liv develop similar private equity portfolios in the future? If so, will you structure them to be tradable? And how will you exit them?

No, there are no such plans at the moment, mainly due to the demands on investment manager manpower to manage this asset class.

6. Will Skandia Liv be a buyer of secondary private equity portfolios?

In the short and medium-term perspective the answer is no. We earn more money by investing in funds. However, there have been strategy shifts before in the history of Skandia Liv, so I cannot rule out a possible future change of course. Skandia Liv will certainly continue to be an investor in private equity, but this will take the form of investing in primaries i.e. investments into funds at the time of their inception.

7. What are your expectations for the development of the secondary private equity portfolio market in Sweden? Will it be a substantial growth sector?

I don't think this will develop into a substantial growth market in Sweden in the near or medium-term future. Rather, I think that business volume might go down near-term. Much of the activity in recent years has actually been the effect of the down-turn following the millennium hype. I do not know of any secondary private equity transaction being negotiated or prepared in Sweden at present.

8. Do you see that an institutionalized market place for the secondary private equity portfolio market will develop in Sweden?

No, I don't think it will because Sweden represents a too small market for such a marketplace to develop. You should remember that the global private equity fundraising last year was approximately USD 227 bn, whereof the US represented two thirds and Europe one third. NYPPE is serving the US market which is more than fifty times larger than the Swedish at present and I don't think that Sweden will reach a size justifying an institutionalized marketplace for private equity secondaries within many years, if at all.

Case study 2: The creation of the new Småföretagsinvest based on the old Aldano.

Interview 2.1: Aldano buys Småföretagsinvest and Fylkinvest. Q&A with Magnus Ekqvist[27], Investment Manager of Småföretagsinvest

1. Please describe Småföretagsinvest AB and its business idea.

Småföretagsinvest AB today consists of Aldano AB and Arbustum Invest AB with assets of about 300 MSEK whereof about 45 % is cash. There are 5 persons in the management team with varied experiences and backgrounds. The combined portfolios include holdings in 25 Swedish small and medium-sized industrial companies, each with a turnover of 10-200 MSEK where co-owners are e.g. governmental funds, VCs and founders. Aldano was originally founded in 1999 by Industrifonden 44 % and Konsortiet 56 %, which consisted of 31 private individuals with entrepreneurial and industrial profiles. The blind pool paid-in capital base of Aldano was 114 MSEK. There were originally 4 persons in the management team and the investment criteria were minority investments in small companies in the Stockholm/Mälardalen area that were preferably in expansion stages.

2. Can you describe the target funds and the end structure?

In June 2002, when Aldano's portfolio consisted of five holdings together with 22 MSEK cash, the possible merger with two funds emerged, namely Småföretagsinvest AB and Fylkinvest AB. Småföretagsinvest had a portfolio of 18 holdings whereas Fylkinvest AB had 9 holdings in its portfolio. The owners of Småföretagsinvest were the Swedish pension fund Sjätte AP-fonden at 75 % together with Svenska Handelsbanken at 25 %. The owners of Fylkinvest AB were Sjätte AP-fonden at 75 % and Nordea at 25 %. After these transactions the combined portfolios at the end of 2002 consisted of a total of 34 holdings.

[27] Magnus Ekqvist worked for KPMG before and joined Aldano in 2000 when it was just established. Now he is the investment manager of Småföretagsinvest, which is the successor of Aldano.

3. Why did the previous owners of Småföretagsinvest and Fylkinvest decide to divest their funds?

The Swedish pension fund Sjätte AP-fonden became involved in direct holdings of small and medium-sized Swedish companies during the years 1996-2001, especially in 97 and 98, when it invested in more risky assets. These holdings became a difficult management challenge to Sjätte AP-fonden which had no in-house resources to cope with many ownership issues that develop with these types of companies, some of them in early stages. Thus, Sjätte AP-fonden made a strategic decision to leave direct ownership of such companies and together with their close partners Svenska Handelsbanken and Nordea they put their holdings up for sale.

4. Why was Aldano interested to acquire?

One of the owners of Aldano was Industrifonden, which had former contacts with Sjätte AP-fonden. This was why Aldano was involved initially. Although not all the portfolio holding of Småföretagsinvest and Fylkinvest fitted the investment criteria of Aldano, there were enough good fits to justify our interest to acquire, such as quite a few companies with very good potential, available cash, and a possibility to acquire these portfolios with a discount. Our plan included that those companies that did not fit our investment criteria should be quickly divested to other owners after our acquisition of the two portfolios.

5. Were there any external financial advisors involved in this transaction?

No external financial advisors were involved because the sellers and the buyer had such competence in-house.

6. What process was involved when the previous owners of Småföretagsinvest and Fylkinvest divested their funds: Structured sale, auction or some other procedure?

I would not describe these transactions as an auction nor as a structured sale. These transactions took the form of negotiated sales because of its inherent complicated structures. But I can tell you that the negotiations between Aldano and the sellers were at times very tough indeed. And maybe there were bidders offering higher purchasing prices, but finally Sjätte AP-fonden came back to us to continue the negotiations. Our competitive edges were that we had the capabilities to take care of all the portfolios and we were serious players with no speculations, and the whole deal was offered cash up-front from us.

7. How long time did the acquisition process take?

Sjätte AP-fonden contacted Industrifonden in April 2002 and the negotiation process continued from June to October. The deal was done in Nov 2002. All in all the process required about six months until closing.

8. Can you give us any comments on the aspects of valuation?

Generally in 2002, the market was hitting a bottom level. We made detailed analysis of NAV, P/E valuations for each of the 29 portfolio companies and market analysis which resulted in guidelines for our negotiations with the sellers. We divided the companies into 3 groups, namely with potential investment worth, wait and see worth, and to be sold targets. And we needed to make a composite analysis of our management team strength and the jewels in the portfolios to see if they matched in the future. Of course the final price is confidential but as you can see from our press release after this transaction most of the available cash position in Aldano at the time was used for the payment.

9. Can you please comment upon the development of these portfolios after the acquisition?

- Have you divested any companies from the original portfolio?

- Have you made any add-on acquisitions to the portfolio companies?

- Are there any jewels which merit special comments?

- Are there any lemons?

We have divested a total of eight companies from the original portfolios. Some of the portfolio companies have required add-on investments but no add-on acquisitions yet. There are certainly a few jewels but for confidentiality reasons I cannot comment on them specifically. As usual there are also one or two lemons but I do not want to comment on them specifically.

10. Any other relevant comments on this transaction?

It is now three years since these transactions took place. When I look back I can say that we are very satisfied with the developments of these portfolios. Through the many experienced businessmen in our ownership structure we have been able to quickly evaluate the new holdings and implement new strategies where needed. In a few more years' time I think that we will be able to deliver some very good success stories from this portfolio.

Interview 2.2: Aldano joins Arbustum Invest under the name Småföretagsinvest, Q&A with Magnus Ekqvist, Investment Manager of Småföretagsinvest

1. Please describe the background of the merger between Aldano and Arbustum.

Aldano and Arbustum both belonged to the same family of regional venture capital companies closely associated with Industrifonden and both had private owners with entrepreneurial and industrial profiles. In addition, Arbustum also had Volvo Aero, Saab Bofors and the Bofors Foundation as institutional investors. The owners of Aldano were Industrifonden at 44 % together with Konsortiet at 56 %. The owners of Arbustum were Volvo 35 %, the Bofors Foundation 15 % and Industrifonden 50 %.

2. Can you describe Arbustum and the end structure?

When this merger came up in April 2004, Arbustum consisted of 5 holdings in Swedish small industrial companies. After the merger the end structure became a mother company carrying the name of Småföretagsinvest AB with two wholly owned subsidiary fund companies named Aldano AB and Arbustum Invest AB.

3. Why did the previous owners of Arbustum decide to divest the company?

Both Aldano and Arbustum had defined their geographical area as the Mälardalen region and the idea came up to join forces to become a unified stronger entity. Furthermore, one of the industrial owners of Arbustum, the Bofors Foundation, wanted to reallocate its investment in Arbustum towards new companies in early stages.

4. Why was Småföretagsinvest interested to acquire?

Most of the holdings of Arbustum corresponded well to the investment criteria of Aldano. Arbustum further had a substantial cash position whereas the Aldano structure that was created after the acquisitions of Småföretagsinvest and Fylkinvest had a rather weak cash position. The synergy effects would make Aldano stronger and enable it to handle bigger deals.

5. Were there any external financial advisors involved in this transaction?

Aldano had their own in-house financial expertise while Arbustum did not. Both invited lawyers to deal with complex tax effects.

6. What process was involved when the previous owners of Arbustum divested the fund: Structured sale, auction or some other procedure?

As Industrifonden was the major owner of Aldano as well as Arbustum, the merger process did not involve any external possible buyers

.

7. How long time did the merger process take?

The merger process took about six months from April 2004 to Nov 2004 to complete.

8. Can you give us any comments on the aspects of valuation?

The commercial details of a transaction like this need to be confidential. We used NAV as well as DCF to find positions for the negotiations of the values. Both sides made their own portfolio valuations first and then made a comment to the other side.

9. Can you please comment upon the development of this portfolio after the acquisition?

- Have you divested any companies from the original portfolio?

- Have you made any add-on acquisitions to the portfolio companies?

- Are there any jewels which merit special comments?

- Are there any lemons?

Four companies have been divested from the portfolio of Arbustum and no add-on acquisitions have been made to the portfolio companies. We expect at least one jewel to come out of this portfolio but we are not presently keeping any lemons. As to the jewels, a company named Tobik originally from Fylkinvest, established in 1999 runs really well. Another company named Reflex originally from Aldano has grown its turnover from 10 MSEK in 2001 to 47 MSEK in 2004, i.e. an annual yearly growth rate at 40 %. As to the lemons, just one out of 23 portfolio companies is losing money but not too much.

10. Any other relevant comments on this transaction?

I would like to underline two of the main benefits of this transaction: One is of course the fact that we created a much stronger entity capable of engaging in a broader niche of potential size. A second aspect is the re-emerging of Småföretagsinvest as the profile of the new entity. This is a company name under which our managing director, Bo Thorsson, has been working for almost 15 years and I think it carries a very strong and positive message in our market segment.

Interview 2.3: Bo Thorsson, MD Småföretagsinvest.

We have had the opportunity to interview Bo Thorsson, MD in Småföretagsinvest, about his opinion of the future possible development of secondary private equity in Sweden: “Secondary private equity is established in Sweden and well established in the US and in UK. If you wait another three or four years I am sure the concept will be established by more players and it will also be possible to raise new money to finance ventures around secondary direct. Of course Stockholm is a very small market place compared to London and New York so there will not be room for too many secondary direct private equity investors. For those that will establish themselves here I think the structure will be rather similar to the situation in the big Anglo-Saxon countries. You should follow the development of the Norwegian Four Seasons management which has spelled out a strategy of investing in secondaries in Sweden. I don’t think that they will be alone in the future but neither will there be a dozen players of this sort.”

Case study 3: Ledstiernan buys Speed Ventures

Interview 3.1: Q&A with Göran E Larsson, vice chairman of Effnet Holding AB, listed on Nya Marknaden, who was closely involved as a bidder in the transaction.

1. Describe Effnet Holding and its main activities.

The Effnet Group was founded on advanced technology developed by scientists at the Luleå University of Technology in 1997 and was listed 1999 on Nya Marknaden. During 1999 and 2000 Effnet Group was substantially capitalized from new issues in the market. In 2001 it was obvious that the development of the basic technology did not require all of the available liquidity and consequently the board started to look for acquisitions. During this process we came upon Speed Ventures NV. Let me point out already now that our bid for Speed Ventures failed and Effnet Group developed in another direction through its later acquisition of a real estate company and subsequent splitting of the Effnet Group into two new listed companies, Effnet Holding and Sagax.

2. How were you involved in the Speed Ventures transaction?

We were contacted by the management of Speed Ventures with a proposal to negotiate a merger. Later we were referred to the financial advisors of the sellers, Keystone Advisors AB, and our negotiations continued with them.

3. Can you describe the target company?

Speed Ventures was originally formed in 1998 to act as an incubator and business catalyst focusing on internet and wireless companies on a pan-European basis. It was later repositioned to become a focused early stage investor with investments in technology companies within the IP/telecom space. Speed Ventures in 2001 had its headquarter in Stockholm with subsidiaries in Helsinki and Milan. Speed Ventures' total investment in its portfolio companies had a book value of about 150 MSEK with an estimated current NAV of about 140 MSEK. In addition Speed Ventures had a cash position of about 150 MSEK. Speed Ventures consisted of 13 portfolio holdings divided between 5 strategic holdings and 8 financial holdings. Each holding represented an ownership of 2.8 % up to 50.6 %.

4. Why did the previous owners of Speed Ventures decide to divest the portfolio?

In 2001 the owners of Speed Ventures consisted of the founders representing 26 % followed by mainly non-domestic financial institutions ranging each from 12 % and down. Due to preferential shares the control of Speed Ventures was firmly in the hands of the financial institutions who were very frustrated with the historic development of the company. They had signed up substantial amounts in the issues to the market during the years 1999-2001 and at this point required liquidity.

5. Why was Effnet Group interested to acquire Speed Ventures?

We believed that some of the portfolio holdings could be developed into successful companies. However, they were all in early stages, which made all attempts at valuation become extremely difficult. In addition, we were convinced that we could achieve very good returns on Speed Ventures' cash using it on other projects and not necessarily the portfolio holdings of Speed Ventures.

6. Were there any external financial advisors involved? If so, what functions did buyer, seller and advisors divide between themselves?

The sellers had contacted Keystone Advisors as their external financial advisor. As regard to Effnet Group, we had this competence in-house and this was why we did not retain any external financial advisor. Regarding Ledstiernan, who was the successful bidder, I believe that they similarly used internal capabilities instead of an external financial advisor.

7. How many buyer candidates would you estimate to have been on the list?

My best estimate would be that there were between five and ten buyer candidates to start with. After a while there were Ledstiernan, Effnet Group and maybe somebody else left.

8. How long time did the selling process take?

My estimate is that the sellers had been working with this process during a couple of months before we came in. Then there were another three months before the transaction was completed with Ledstiernan as the buyer.

9. Can you give us any comments on the aspects of valuation?

This needs to be kept confidential but our principle was to value Speed Ventures' cash position at nominal value whereas the shares in the portfolio companies were valued very low, very far below net asset value.

10. Why was your bid unsuccessful?

We had professional discussions with the advisors of the seller and with Speed Venture's management. We also packaged our bid in a professional way. However, as Ledstiernan had valued the shares in Speed Ventures' portfolio companies higher than we had, the bid from Ledstiernan was higher.

11. Any other relevant comments on this transaction?

From the perspective of a secondary direct transaction, the Speed Ventures transaction was somewhat special. Both from the fact that Speed Ventures had an unusually big cash position but also from the fact that there was no visible jewel in their portfolio. Also the fact that practically all portfolio holdings were very early stage ventures. Thus the portfolio was extremely difficult to value and I think most buyers focused on the cash position.

Case study 4: Other Swedish transactions with a secondary private equity character

Research of press releases from ten Swedish private equity companies.

We have researched the press releases from the leading and medium-sized Swedish private equity companies since 1999 to try to find secondary direct or secondary funds activities. The following companies have been researched: Industrikapital, Nordic Capital, EQT, Ratos, Procuritas, 3i Nordic, Permira, Capman, Sjätte AP-fonden and Affärsstrategerna. The absolute majority of transactions reported in these press releases have been traditional acquisitions of all or parts of one company at a time. However, we have also found a rare number of transactions that could be classified as secondary private equity portfolio transactions: Industrikapital buying 9 companies from Telia in 2001, subsequently named the Telefoss group. Ratos sold in 1999 a portfolio of holdings to Mikael Karlsson's Visionalis. In 2001 Ratos together with 3i bought Atle with its portfolio of many Swedish companies. Apart from the Prosper Fund acquisition from Skandia Liv in 2005 (reported on above, see case study 1) there is no other secondary private equity activity reported by 3i Nordic. Apart from their divestment in 2002 to Småföretagsinvest/Aldano (reported on above) there is no other example of secondary private equity activity from Sjätte AP-fonden. Affärsstrategerna acquired in 2001Innovationsmäklarna including all holdings in that portfolio. Nordic Capital, EQT, Procuritas, Permira and Capman did not carry any entry during the study period which could be classified as a secondary direct or secondary fund transaction.

Case Study 5: Cogent Partners

Interview 5.1: Q & A with Brenlen Jinkens, Managing Director of Cogent Partners, London.

1. Please describe Cogent and its main activities.

Cogent Partners is a private equity focused investment bank dedicated to serving the needs of the private equity community. Cogent Partners represents sellers in traditional and securitized secondary transactions, conducts detailed portfolio assessment and pricing analysis, and provides fairness assessments for secondary buyers and sellers.

2. Could you describe your activities as regards secondary private equity portfolio transactions?

See above.

3. What significance does this asset class have for Cogent?

It is important to note that Cogent Partners is strictly an advisor and we do not take any position ourselves in secondaries. Secondaries have great significance to Cogent Partners as it is our sole market niche.

4. We have researched secondary private equity portfolio transactions in Sweden during the last seven years. We have also read about the much more active US situation. Could you please give us some comments on secondary private equity portfolio transactions in the UK?

Instead of talking about the UK I find it more meaningful to talk about Europe. The European market for secondaries has a distinct difference from that market in the US in as much as secondary directs are relatively much more common in Europe. In the US indirect transactions through fund shares is the dominant business structure in secondaries. Within Europe there are of course some differences and on a relative basis more activity can be found in Switzerland, Germany and the UK than in other European countries. You should note the important fact that the development of secondaries is closely related to the development of primaries. This explains the heavy secondaries activity in Germany a few years after the millennium change which was a direct consequence of the very accelerated activity in primaries in Germany at the end of the nineties. Another observation which is relevant to your country is that activities in primaries (e.g. VC activity) started much earlier in Finland and Sweden than in e.g. Germany where such activity was almost unheard of until the end of the nineties. Sweden had a substantial primary VC activity already during the first half of the eighties.

5. Will Cogent in the future be a buyer, a seller, or both, of secondary private equity portfolios?

Reference earlier profiling of Cogent you will understand that we are only an advisor and thus do not take a buyer or seller position ourselves.

6. What are your expectations for the future development of the secondary private equity market in the UK? Will it be a substantial growth sector? What development, if any, do you foresee for Sweden?

Secondaries in Europe will definitely be a growth sector in the future and again this will be explained by the trend of increasing primary investments. The market for secondaries will have its bumps up and down and you will be able to relate them to similar bumps in the primaries market development. However, the secondaries will be time lagged to the primaries usually several years.

7. What are your expectations for the future development of the secondary private equity market in Sweden? Will it be a substantial growth sector?

Compared to several other countries in Europe, Sweden has been an early adopter of the concept of primary private equity and I would not be surprised if Sweden will also develop the market for secondaries more rapidly than many other European countries. We are actually launching an event on the 1st of June this year together with the SVCA[28] focusing on the development of secondaries and we do this because Sweden will be an interesting country for the development of this asset class in Northern Europe and it should be a growth sector in your country.

[28] The Swedish Venture Capital Association

8. Do you see that an institutionalized marketplace (similar to NYPPE) for the secondary private equity market will develop anywhere in Europe? In the UK? In Sweden?

Please remember that NYPPE is not a big thing in the US. NYPPE is doing a certain job in putting buyers and sellers together but most of this activity is done outside the NYPPE exchange. I don't think that there will develop a similar institution in Europe, not even in the long run. Buyers and sellers will also on this continent learn to find each other through advisory help from companies like ourselves and our colleagues. And, of course, in Sweden today the market for this type of transactions is much too small to justify an institution similar to NYPPE.

Due Diligence

Secondary transactions require an extensive legal and financial due diligence process. Below we have listed some major headlines of a typical due diligence investigation.

A. General requirements

1. Description of the company group, subsidiaries and any affiliates. This may be supplemented by an organization chart.
2. Articles of association and certificates of registration for each group and affiliate. This may be obtained in Swedish or English..
3. Names, addresses and telephone numbers to offices and plants of the group.
4. Board and shareholder meeting minutes (for a selected number of years).
5. Annual reports of the group and any affiliates (for a selected number of years).
6. As the case may be, “audit response letter” for a selected number of years.
7. Any shareholders’ agreements and any agreements between the company and any affiliates, companies or persons.

B. Capital

1. Share ledgers for all group companies
2. Issued shares, options, convertible loans or other documents according to chapters 4,5 or 6 of the Swedish Companies Act.

C. Certain Legal Aspects

1. Judgements, orders, decision, and arbitration award concerning any group company or affiliate
2. Claims made or threatened to be made by public authorities or other third persons for claimed violations of regulations, ordinances or laws, or judicial decisions or judgments.
3. Licenses, permits, approval by authorities, etc
4. Pending or threatened disputes (whether civil, administrative, tax, or criminal

5. Other notices from or to a public authority (or the corresponding) with a content that may affect the business

D. Other Legal Aspects

1. Copies of any floating charge certificates (Sw. “graviationsbevis”) with respect to any floating charges on the assets of each group company.
2. Other encumbrances on the property of each group company.

E. Assets

1. Patents (granted, pending)
2. Trademarks
3. Copyrights (e.g. any software) and franchise rights
4. Trade secrets
5. Actual or claimed infringements in the intellectual property right of a third person.
6. Other intellectual property rights of material significance to the company/group

F. Agreements

1. Agreement restricting the right to do business on a geographic or other basis
2. Samples of all group standard agreements
3. Samples of all group standard warranties
4. Maintenance agreements
5. Licenses, royalty, confidentiality, and non-competition agreements.
6. Service, and technical support agreements
7. Agreements entitling either party to a commission or similar compensation
8. Other material agreements (according to a set definition, e.g., as to minimum amounts or duration)
9. Specific list of agreements affected by a charge of ownership or contraol of a group company

G. Employees

1. List of all employees, stating salaries and other employment benefits
2. Employment agreements
3. Any collective bargaining agreements
4. Unions organizing the employees
5. Pensions
6. Employee housing benefits
7. Holiday benefits
8. Loans to employees
9. Guarantees for debts of employees
10. Company cars
11. Other benefits in kind

H. Insurance

1. List of insurance policies of the group
2. Insurance agreements.

I. Real estate

1. List of owned and rented property
2. Title certificates and certificates of encumbrance
3. Agreements concerning real property, e.g., rental agreements

Glossary

Blind pool	Funds are invested in a company or fund where there initially are no investments/projects/companies.
Closed-end fund	Usually private equity fund with limited life.
Due Diligence	Close examination of a target company or portfolio in respect of its legal and/or financial situation.
Fund of funds	A fund where all assets are shares in other funds.
General Partner (GP)	Also called managing partner, assuming a special responsibility cf to Limited Partners in respect of the management of one or several private equity funds.
IPO	Initial Public Offering, the process whereupon a company is being listed on a securities exchange.
J-curve	The value development of an investment/company from its inception.
Jewel	An economically very successful investment.
LBO	Leveraged Buy-Out i.e. a buy-out financed by substantial external credits.
Limited Partner (LP)	Investor in a private equity fund who risks his investment only but is not required to take any management responsibility for the fund(s)
MBI	Management Buy-In i.e. external management buys target company from previous owners.
MBO	Management Buy-Out i.e. existing management buys target company from previous owners.
NAV	Net Asset Value, the difference between total assets and total liabilities.
Private Equity	Equity invested in a company that is not listed
Secondary fund	A fund consisting of private equity secondaries.
Secondaries	Shares in a private equity fund that are traded to new owners.
Secondary direct	All shares in a private equity fund are acquired by an investor who thereby becomes a “direct” owner in all the portfolio companies.
Venture Capital	A subclass of private equity focusing on the seed, start-up and expansion phases..