QMS Firm Estimates 20% of Funds Have Already Maxed Out On Secondary Sales for 2009

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As you may remember, private equity firms need to be careful about the amount of secondary exchanges between their investors. If a firm exceeds 2%, a set of mildly draconian rules require it to register as a public partnership.

As explained in a previous blog post, a firm can see up to 10% trade if it uses a qualified matching service, or QMS. With all eyes on the secondary market, it's no surprise that QMS service providers have seen an uptick in business.

Lawrence Allen, a managing member of QMS provider NYPPEX, estimates that 20% of all buyout funds have already hit their 2% target for this year. Meanwhile, he predicts that number will increase to 50% by June.

Allen said he's seen countless instances of an LP preping a secondary offering, only to be denied the sale by the GP (they have to approve any sale), because the fund has already hit its 2% mark.

Of course, secondary transactions haven't exploded as expected this year because buyers are still waiting for year-end numbers to come out. Deals are beginning to pick up as those numbers trickle in, Allen said. He said the action has increased in two places:

- Small, single interest transactions, where the seller has basically accepted the deeply discounted market price for its holdings.
- Larger, structured transactions that include a JV between the buyer and seller. This precludes a change-of-control provision and can help the general partner keep less than 2% or 10% from officially changing hands.

NYPPEX offers its own version of the latter, in which the firm sets up tranches in the JV. The LP contributes its assets and the buyer contributes capital, which the LP can withdraw. The buyer agrees to fund future capital calls and requires a 1.5x return before and distributions reach the LP. From that point any returns are split 50/50. We've covered other examples of this type of work-around, most recently one from Probitas Partners called Prospectives.

The one thing about the QMS that amazes me is a GP's seeming embarrassment of having set one up. I've talked to more than a few PE pros who refused to admit to me they'd set up a QMS for secondary trades. The only one that's admitted it on the record is Sun Capital. The firm hasn't seen even close to 2% trade in any of its funds yet, but has a QMS to be prepared in case that happened, Sun Capital's Co-Head Rodger Krouse told me during a keynote interview with him at Buyouts East yesterday. It seems simple enough.

Perhaps other firms are afraid it'll incite fear in the minds of their investors. "That must mean lots of other LPs want to sell, maybe there's something they know that I don't…"

To this I say, really? There's enough news of cash-constrained LPs out there that I think having shares of a fund trade on the secondary market doesn't necessarily reflect badly on the fund. It's not just the bad funds trading on the secondary market—there's a mix of everything. I don't see a problem with a firm setting up a QMS as a service to LPs. Am I wrong?

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