The Private Equity Secondary Market

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For further reading:

- Eli Talmor, Florin Vasvari, London Business School (2011), *International Private Equity*, chapter 9: Secondaries fund transactions (Wiley)

Evolution of the market

Private equity's secondary market exists to provide liquidity in an illiquid asset class; it allows private equity investors (often known as Limited Partners or LPs), to exit early from their investment commitments.

Investors sell assets as 'secondaries' for a range of reasons, including a desire to:

- Achieve early liquidity from their private equity holdings
- Manage the overall composition of their private equity portfolios
- Modify their business models in response to regulatory or strategic change

The secondary market was originally restricted largely to the sale and purchase of Limited Partner interests in individual private equity funds or portfolios of funds. Purchasers acquired investors' interests in the funds' remaining assets, and took on their commitments to meet future capital calls.

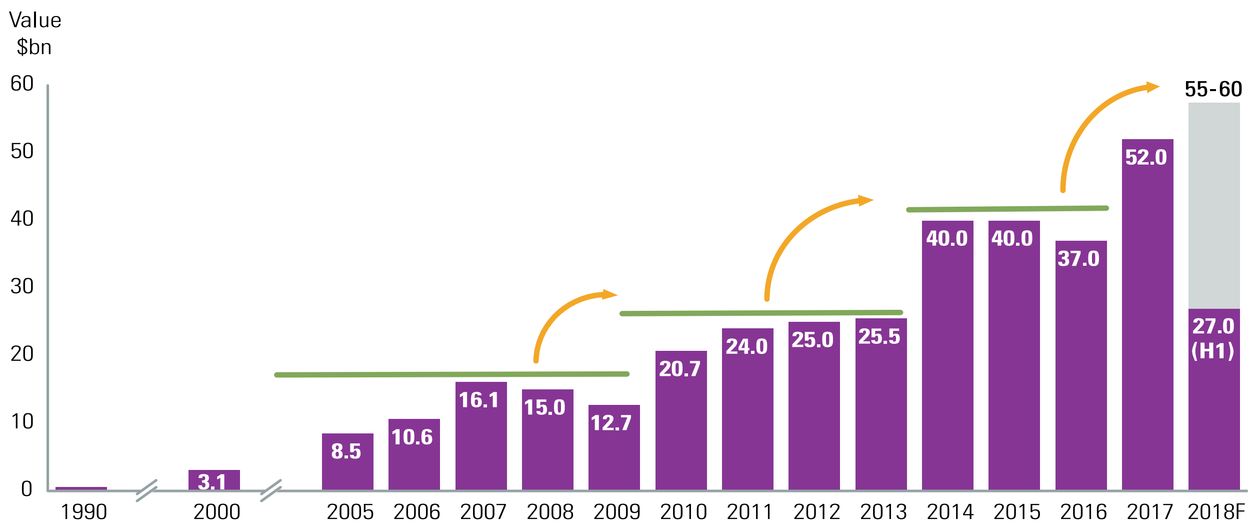
From its early days as a forum for the exchange of fund interests, the secondary market evolved to embrace interests in private companies not held within independent private equity funds.

These transactions are known as direct secondaries (or sometimes simply as 'directs').

In recent years, GP-led (as opposed to investor-led) secondaries have become an increasingly important part of the market. GP-led transactions involve interests in the assets or investor commitments of individual, mature private equity funds.

The secondary market has experienced rapid growth over the last decade *(Figure 1)* as the private equity asset class has grown and matured.

Private equity secondary transactions 2005-2018(F)



Source: Coller Capital, based on market consensus. 2018 forecast is presented for illustrative purposes only; actual market volumes can differ materially from predictions.

Figure 1

Why investors commit to secondary funds

Institutional investors have increasingly acknowledged the benefits of secondary funds in providing exposure to private equity across economic and market cycles. Capital commitments to secondary funds have, in consequence, grown consistently over the past decade.

Investors make secondary fund commitments for a number of reasons:

To generate attractive risk-weighted returns

The heterogeneous nature of private equity means that its secondary market is characterised by significant price and information inefficiencies. These inefficiencies can enable secondary players to generate superior risk-adjusted returns.

The 'blind-pool' risks associated with primary fund commitments are substantially reduced for secondary funds. Because secondary funds typically invest in mature, substantially-invested portfolios, they should be able to generate attractive returns with a significantly lower risk than primary funds.

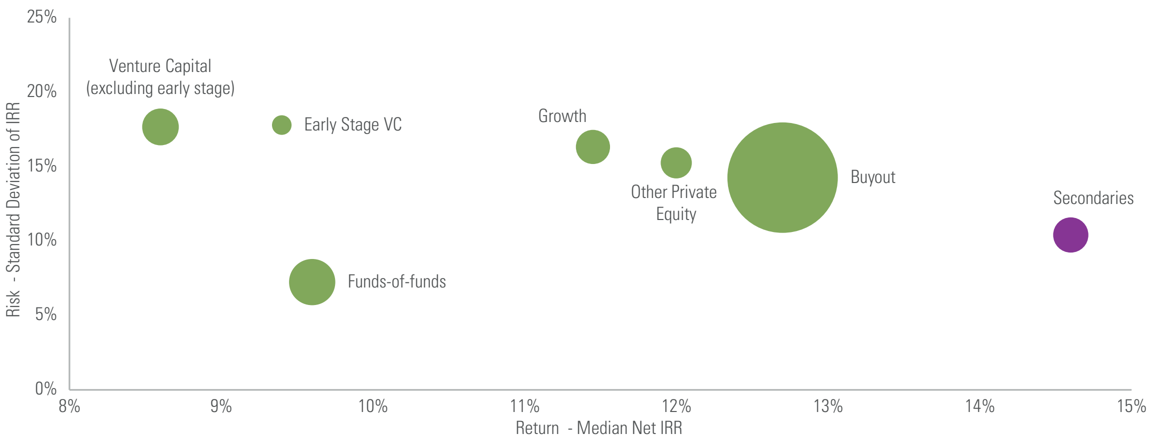
Analysis by research company Preqin into private equity strategies over the last decade supports this *(Figure 2)*. It shows an attractive risk-return profile for secondary funds, compared with other private equity strategies.

To diversify their portfolios

Secondary funds offer institutional investors substantial diversification. Like broad-based funds-of-funds, secondary funds can provide investors with diversification by investment stage, geography, industry sector and fund manager.

Moreover, secondary funds offer the additional advantage of diversification by vintage year. This ability to back-fill a portfolio with a range of historic vintages is particularly valuable to investors new to the private equity asset class.

Risk-return profile of private equity strategies



Note: Data as of June 2017; Vintages 2004-2014
Source: Preqin

Figure 2

To smooth the 'J-curve' effect

During the initial phases of private equity investments, an institutional investor typically experiences a period of negative returns as a portfolio's underlying fund managers draw capital for investments and management fees. This phenomenon is referred to as the 'J-curve' effect.

As *Figure 3* shows, performance typically improves gradually as portfolio investments benefit from value creation and the realisation of assets.

Secondary funds are able to mitigate the 'J-curve' effect by acquiring positions in mature primary funds (typically over five years old, with over half of fund commitments drawn down from investors) in which the underlying portfolio companies are closer to exit. Since secondary funds typically return cash faster than buyout funds or funds-of-funds, investors also have significantly reduced capital at risk *(Figures 4 & 5)*.

To gain insight into individual GPs

The broad diversification of secondary funds' holdings can provide their managers with valuable insights into the strengths, weaknesses and strategies of primary market GPs.

Investors should be able to benefit from these market insights, reducing the risks of making new commitments – first-time commitments in particular.

The private equity J-curve

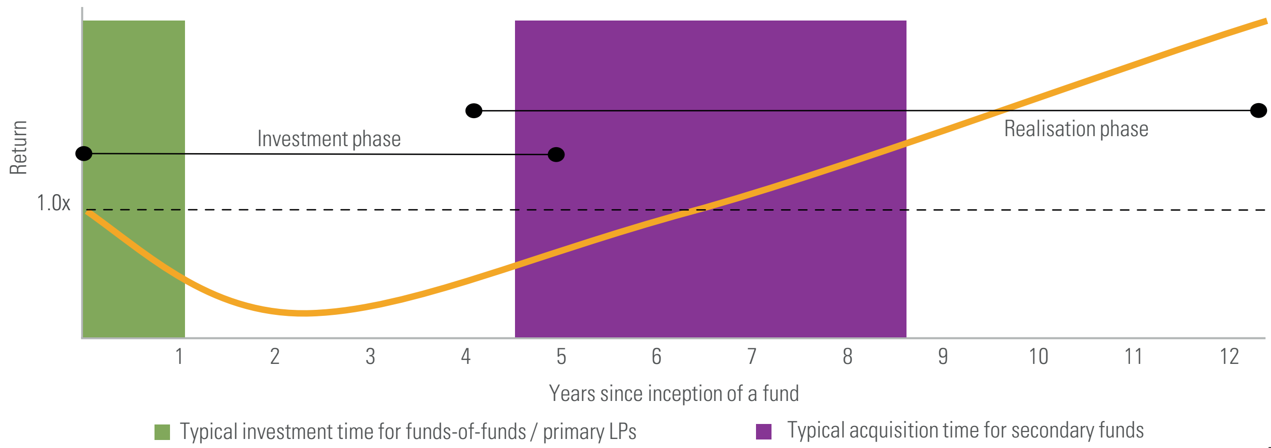


Figure 3

Average years to achieve 1.0x Distribution to Paid-in (DPI)

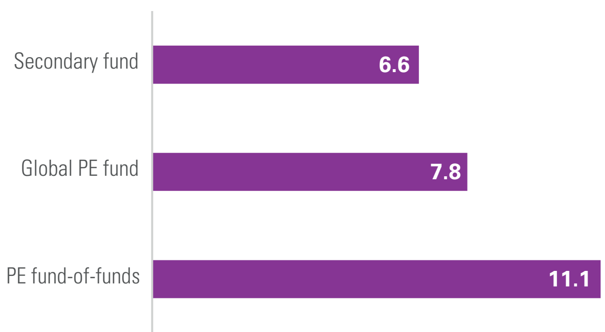
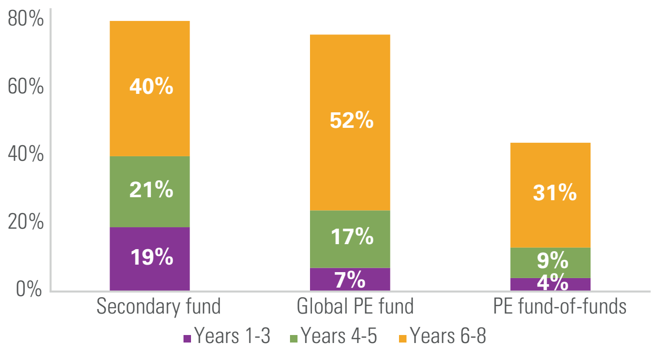


Figure 4

Average percentage of LP capital distributed



Source: Cambridge Associates, "When secondaries should come first", reasearch note July 2017. Data as of June 30, 2016

Figure 5

Why investors sell assets in the secondary market

Private equity is an inherently illiquid asset class. A typical private equity fund has a nominal life of 10 years – and the actual lives of funds have stretched well beyond this point since the global financial crisis.

When LPs' priorities and strategies change, as they inevitably do over time, the secondary market allows them to exit their commitments before the end of their funds' lives. The recent growth of the secondary market is therefore simply a natural consequence of the immense volume and variety of private equity commitments made in recent years *(Figure 6)*.

One way to understand the different types of secondary transactions in today's market is to look at the motivations of those initiating them.

Tactical sellers

Today's investors constantly adjust their asset allocations in response to changing market conditions. And in the wake of the financial crisis especially, many private equity investors found themselves with portfolios created for a pre-crisis world.

Many of these investors have been 'tactical sellers', taking advantage of good liquidity and attractive pricing in the secondary market to accelerate the re-shaping of their private equity portfolios – by vintage year, investment stage, investment type, manager exposure, and geography.

Tactical sellers have been the largest group of sellers in the secondary market for several years, accounting for around two thirds of 2017 transaction value, for example *(Figure 7)*. They are likely to remain so in the absence of significant market dislocations, because today's LPs take a much more proactive approach to managing their portfolios than they did in the early days of the private equity market.

Strategic sellers

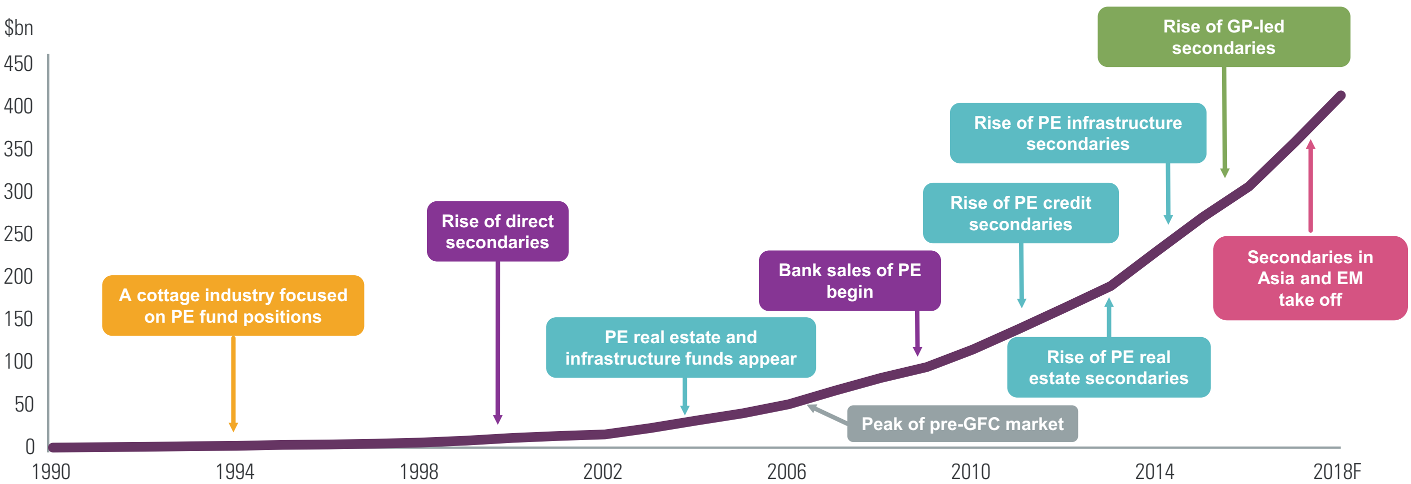
Major changes in Limited Partners' investment strategies can occur for any number of reasons:

- Personnel moves (such as the appointment of a new Chief Investment Officer)
- Changes in investment mandate or business model
- New regulatory requirements (such as the Volcker Rule in the US)
- Mergers and acquisitions among asset owners

When these changes happen, they often result in business lines and assets becoming superfluous to requirements or no longer appropriate for an investor.

The secondary market transactions resulting from these strategic changes are usually significantly more complex than the standard sale-and-purchase of Limited Partner positions in funds.

The secondary market is continuing to respond to new liquidity needs



Source: Coller Capital.

Figure 6

GP-led secondaries

GPs have always used the secondary market for 'tail-end' sales – the wholesale disposal of the 'long tail' of remaining assets in ageing, largely liquidated funds.

In recent years a new segment of the secondary market has appeared as private equity fund managers have begun to take a more proactive approach to managing liquidity for their investors.

GP-led secondaries, as these secondary solutions are known, involve a private equity manager working with a secondary specialist to offer liquidity options to a fund's existing LPs and to secure additional time and capital for the fund's unrealised portfolio.

These transactions are complex and present many challenges – not least in aligning the interests of both the new and remaining investors with those of the sponsoring GP. As a result, they tend to be highly bespoke processes.

These processes – the early examples of which involved funds whose development was particularly affected by the financial crisis – tend to be large rather than numerous. Despite this, they accounted for around one quarter of 2017 market volume *(Figure 8)*.

European GPs have so far been more active in this area than their US counterparts, though intermediaries forecast that activity will increase in the US in the next 12-24 months.[1]

More seller dynamics

Secondaries are still evolving rapidly in less mainstream areas of the private equity market.

Real assets-focused secondary transactions have become increasingly common in recent years as institutional investors have increased their allocations to real assets-focused private equity funds.

The growth of secondaries in private equity real estate has been particularly strong; and private equity investments in natural resources, infrastructure and credit are also increasingly coming to market.

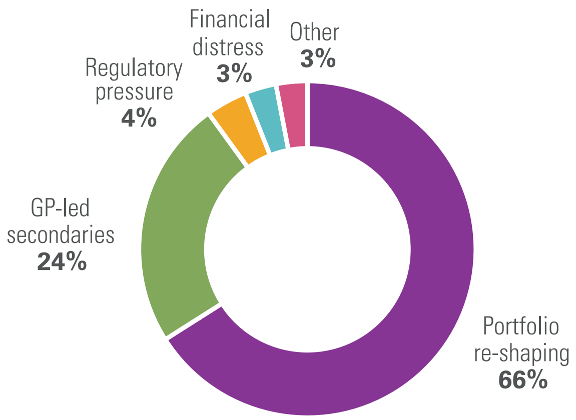
Financial institutions, too, are using the market to dispose of private equity-like assets. These assets share certain similar characteristics with private equity and include collateralised loan obligations and non-performing loans.

Finally, the proportion of sellers from outside the United States and Europe is growing, as the primary private equity market matures in other areas of the world. In 2017, sellers in the rest of the world accounted for 17%[1] of total secondary market volume.

[1] *Greenhill*

Secondary market sales in 2017 – by type of seller and reason for selling

Reason for selling



Source: Evercore Secondary Market Survey 2018
2017 transaction volume (purchase price + unfunded).

Figure 7

Seller type

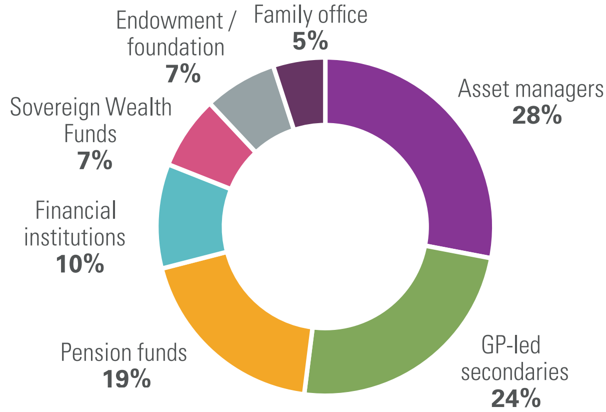


Figure 8

Other market participants

Buyers

The universe of potential buyers for secondaries has expanded over the last decade as investors have come to appreciate the advantages of secondary acquisitions.

Buyers today exhibit a range of characteristics in terms of size, level of specialisation, experience, investment objectives and time horizon.

On the one hand, there are dedicated secondary funds and a number of funds-of-funds for whom buying private equity interests is a major or exclusive investment objective. These groups have historically been referred to as 'traditional' secondary buyers.

On the other hand, there are many buyers who purchase assets in the market on an ad hoc basis – for example, pension funds, banks, family offices, endowments and foundations, and even GPs. These buyers are generally opportunistic, taking advantage of specific opportunities to add to their holdings in GPs or funds that they like.

Advisers

In the market's early years, institutions wishing to obtain liquidity through the secondary market were obliged to set up and run their own sale processes.

The limited resources available to many LPs, and the unfamiliarity of the mechanisms involved, made this daunting. As a result, intermediary firms saw an opportunity to offer secondary advisory services – including portfolio valuation, market research and full, M&A-style sell-side processes.

Today, intermediaries are routinely used in the market, especially by tactical sellers disposing of simple private equity portfolios. Would-be sellers seek advice or assistance in a number of areas: market dynamics; the buyer universe; and process management. The largest secondary advisory firms are: Greenhill, Campbell Lutyens, Park Hill, UBS, Credit Suisse and Evercore.[2]

General Partners

In the majority of secondary transactions the GPs of the funds in which interests are being bought and sold are 'silent partners' – facilitators and approvers of transactions, rather than principals.

These GPs are mainly focused on:

- controlling information about their funds
- reviewing and approving potential purchasers
- responding to due diligence enquiries during the later stages of the sale process
- completing transfer documentation, to move ownership of the interest(s) from seller to buyer

[2] *Preqin, 2018 Global Private Equity and Venture Capital Report*

Types of secondary transaction

Private equity's secondary market was, in its early days, largely about the re-sale of LP fund positions; today it encompasses a far wider variety of transactions. (See also the section headed 'Current market dynamics and prospects').

LP secondaries – PE fund positions

The sale-and-purchase of LP positions in private equity funds is the most commonly seen secondary transaction (representing 63% of transactions in H1 2018).[3]

An LP secondary transaction occurs when a private equity fund investor sells an interest (or a portfolio of interests) to another investor. The purchaser becomes a replacement LP in the fund in question *(Figure 9)* and assumes the original investor's obligations to pay any outstanding commitments to the fund.

This process allows sellers to achieve a variety of objectives: obtain early liquidity; implement changes in strategy or asset allocation; adjust to new regulatory requirements; or 'lock in' fund returns.

Direct secondaries – assets not held in PE fund structures

A direct secondary transaction involves the sale of directly-held investments in private companies – usually by a financial institution or corporate *(Figure 10)*. These transactions differ from normal M&A activity because they involve whole portfolios of discrete holdings, rather than single assets.

Sellers may achieve a number of objectives through 'directs': generate cash/improve liquidity; implement changes in strategy; adjust to new regulatory requirements; avoid the time and cost of selling assets piecemeal; or the spin-out of asset manager teams.

[3] *Evercore 2017 Secondary Market Survey*

Schematic overview of an LP secondary transaction

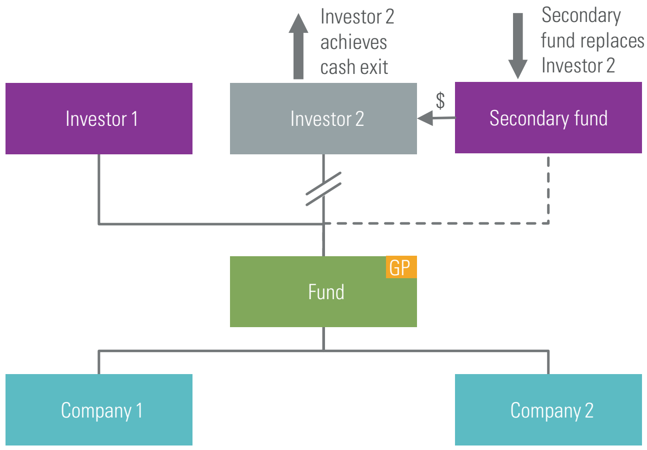


Figure 9

Schematic overview of a direct secondary transaction

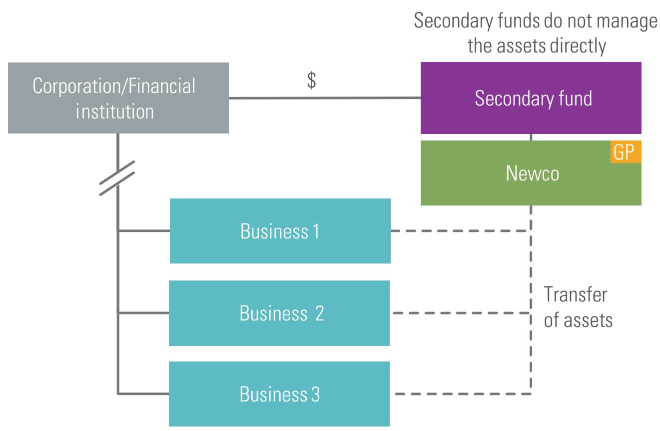


Figure 10

‘Top-up’ capital infusion

In this type of transaction a private equity fund is bolstered by ‘top-up’ capital, which is used to provide capital infusions to the fund’s portfolio companies. The additional capital is injected into the original fund and there is no need to manage a separate fund *(Figure 11)*.

This approach has several benefits: it offers a fund’s LPs the option to commit a proportion of the ‘top-up’ capital; it may avoid the need for a GP to fundraise at an unsuitable time; and it may improve alignment by resetting a GP’s incentives and remuneration.

Tail-end transactions

A tail-end transaction is the sale of the remaining assets in an ageing private equity fund. It provides full and early liquidity to investors, enabling them to accelerate or ‘lock in’ their returns *(Figure 12)*.

For a GP, a tail-end disposal also frees up management resources for other initiatives or funds.

Schematic overview of a ‘top-up’ capital infusion

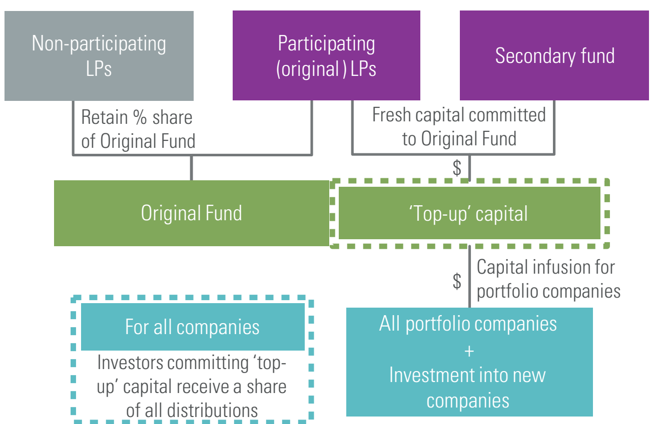


Figure 11

Schematic overview of a tail-end transaction

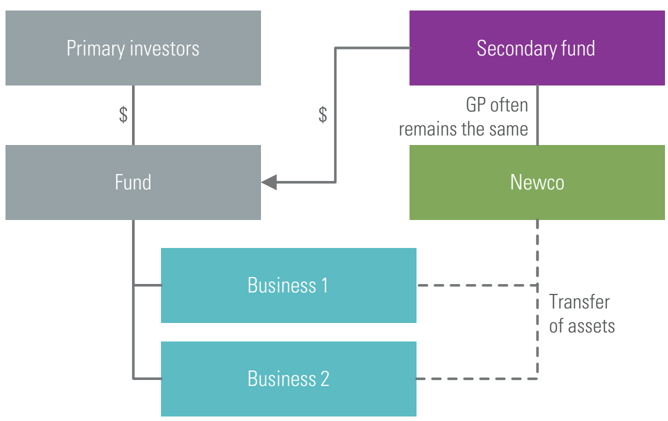


Figure 12

Pricing development

The number of secondary transactions for private equity interests was very small until the mid-1990s, after which it began to expand. Growth in the market started to accelerate rapidly in the early years of the new millennium, and it is still growing fast today.

Secondary pricing reflects this evolution. In the early days of secondaries there was very little in the way of 'market infrastructure' and price discovery was difficult. As a consequence, assets were often sold at significant discounts to NAV.

Today, the market environment looks very different – with numerous specialist and ad hoc buyers, established brokers, committed investors and frequent sales by a disparate universe of asset owners. As would be expected, this increased transparency and efficiency has been reflected in higher pricing.

Average prices at auction have risen from 83% of NAV in 2010 (in the aftermath of the financial crisis) to 93% of NAV in H1 2018 *(Figure 13)*.

(These averages are for all types of private equity asset; pricing for buyout funds is significantly higher, with average high bids at auction reaching 98% of NAV in H1 2018.)

Several cyclical factors have also contributed to higher prices: the recovery in public equity markets; a good exit environment; the availability of debt; and strong fundraising by secondary managers.

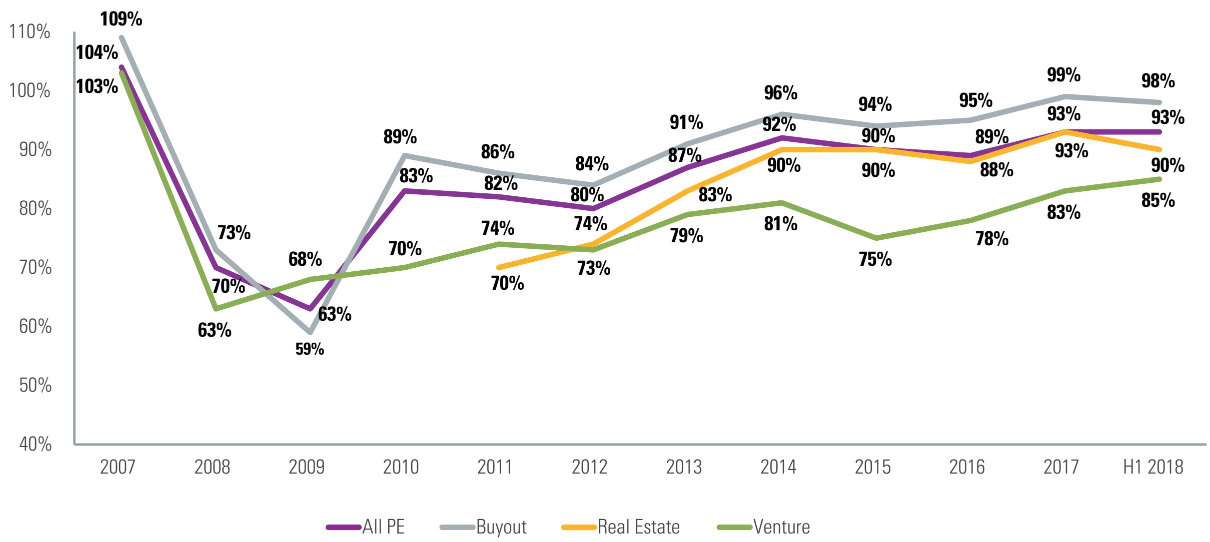
It should be noted that although the move to higher pricing has been common to the whole secondary market, the terms for individual transactions vary significantly from market averages. Brand-name buyout funds sold in 'open-market' auctions attract the fullest prices – the buyers being either secondary funds with a high degree of macroeconomic conviction, or individual investors 'paying up' for positions in funds they favour.

Outside these 'plain vanilla' transactions, however, pricing varies more. Many other factors come into play: the type and mix of assets on offer; the size of a portfolio; the needs of the seller; the openness of the sales process; and transaction complexity.

We expect secondary pricing to remain fairly stable in the medium term – although macroeconomic shocks would lead to wider discounts. (As a general rule, market dislocations create attractive investment opportunities for secondary buyers.)

While pricing has crept higher over the last few years, specialist secondary funds are still seen by many investors as offering an attractive risk-return profile.

Average secondary pricing as a % of NAV



Source: Greenhill, Secondary Market Trends & Outlook 2018

Figure 13

Current market dynamics and prospects

Record market volumes

Compared with the secondary market in quoted equities (which comprises the vast majority of stock exchange transactions), private equity's secondary market is still small, representing less than 3% of total private equity NAV.[4]

Structural differences in the markets for public and private equity mean that the latter's secondary market is likely always to remain smaller (as a proportion of total assets under management) than its public counterpart.

However, private equity's secondary market is nonetheless recording significant growth. In 2017, the volume of transactions set a new record at $52 billion[5] – more than three times its pre-crisis peak in 2007.[6]

The first half of 2018 has already seen $27 billion[5] of secondaries transacted. Coller Capital is forecasting total secondary volume in the range of $55-60 billion[5] for the full year.

This growth is, in part, a simple consequence of the expansion of the primary market. Investors committed approximately $3.6 trillion to the private equity asset class in the decade to 2018.[7]

However, it also reflects two further dynamics:

- the increasingly active approach institutional investors have taken to managing their alternative asset portfolios
- new economic and regulatory realities created by the global financial crisis

Barring significant economic dislocations, the secondary market is expected to remain buoyant for some years to come for the following reasons:

- The large volumes of tactical selling by investors are likely to continue
- GP-led secondaries are expected to be embraced by more blue-chip GPs on both sides of the Atlantic
- The private equity secondary market is still expanding into new assets/areas
- Sellers from beyond Europe and the US are likely to be more strongly represented as the private equity industry comes of age in Asia and the rest of the world

[4] *Coller Capital, Thomson Reuters*

[5] *Coller Capital*

[6] *Greenhill*

[7] *Preqin*

Coller Capital: a track record of closing complex transactions

April 2018
World's largest ever GP-led transaction, a liquidity offer made for €2.2bn to Nordic Capital investors.

March 2018
Acquisition of a portfolio of 45 LP positions, totalling $350m, from Aberdeen Private Equity Fund Limited.

July 2017
Investment of £125m into the public-to-private acquisition of Shawbrook Bank by Pollen Street Capital and BC Partners.

August 2016
Acquisition and spin-out of a $257m portfolio of senior secured loans managed by Northport Capital, into CVC's direct lending platform.

July 2016
A $288m GP-led transaction: a liquidity offer made to J.C. Flowers investors.

July 2015
Commitment of $645m, which allowed Irving Place Capital to reposition its 2006-vintage fund and establish a new investment vehicle.

September 2014
Acquisition of a €175m funds and directs portfolio from a leading Italian bank.

May 2014
Establishment of American Capital's third private equity fund, consisting of seven companies from previous funds, plus capital for new investments.

December 2013
Acquisition of a directs portfolio from Barclays Africa Group (formerly Absa Group), involving management team spin-out.

August 2012
Agreement to fund the purchase of a $1.9bn fund portfolio from Lloyds Banking Group.

December 2011
Acquisition of Crédit Agricole Private Equity (CAPE) and a large majority of the funds CAPE managed.

July 2010
£480m joint venture with Lloyds Banking Group to hold the Bank of Scotland Integrated Finance portfolio.

September 2009
Acquisition of a direct venture asset portfolio of 21 companies from 3i, the British quoted investment trust.

February 2009
Acquisition of a 20% stake via a rights issue and share placement by SVG Capital Plc – the major investor in Permira buyout funds.

Nov 2008 / Feb 2016
Commitment to a series of CLO portfolios totalling $450m across Coller's fifth and seventh funds.

March 2007
$1bn joint venture with Shell to develop a portfolio of 34 investments. Shell Technology Ventures Fund 1 BV is managed by a team spun-out from Shell.

December 2006
€193m joint venture with ABN AMRO, comprising 26 life science assets and an independent management team.

January 2006
Investment in ICICI Venture's India Advantage Fund I. This was India's first secondaries transaction.

September 2005
Acquisition of a £40m portfolio of corporate venture assets from AEA Technology, including Accentus Plc.

September 2004
Purchase of a portfolio of companies from Dresdner Kleinwort Benson, with management team spin-out.

January 2004
Purchase of a portfolio of blue chip buyout funds with a 3.5 year embedded vendor loan.

December 2001
Purchase of a direct venture portfolio from Lucent's Bell Labs, with management team spin-out to form NVP.

June 2000
Formation of a syndicate to acquire a $1bn portfolio of direct and fund assets from the UK's NatWest Bank.

June 1998
In June 1998, Coller Capital's fund purchased the private equity funds portfolio of Shell's US pension fund.

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