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Evolution of the market

The private equity secondary market allows the sale and purchase of investors’ existing interests in buyout, venture and other alternative investment funds, and in portfolios of direct investments in companies.

Purchasers typically acquire interests in a fund’s remaining assets and take on the selling investor’s commitments to meet capital calls in the future.

Historically, secondaries transactions comprised the sale of Limited Partner (LP) interests in individual funds or portfolios of funds. However, the secondary market has evolved to include portfolios of direct investments in operating companies not held in standard fund structures. These investments are known as direct secondaries.

In recent years, GP-led liquidity transactions (involving sale of the assets from, or restructuring of, older vintage funds) have also become increasingly frequent.

The private equity secondary market exists principally to provide liquidity in an illiquid asset class: it is the only way for individual LPs to exit early from their investments. As can be seen in Figure 1, the secondary market has experienced rapid growth over the past decade, as the private equity asset class has grown and matured.

The secondary market, which has tracked the rapid expansion of the primary market, allows PE investors:

- to achieve early liquidity from their PE assets
- to manage their portfolios more proactively
- to modify their business models in response to regulatory or strategic change

Global secondaries transactions by year

Source: Coller Capital.
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 these commitments for a number of reasons:

To generate attractive risk-weighted returns

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

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

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

To diversify their portfolios

Secondary funds offer institutional investors substantial diversification. Like broad-based funds-of-funds, secondary funds provide investors with diversification by investment strategy, 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.

Building an exposure to the secondary market also allows investors to smooth performance by repricing older vintages to current market conditions.

Risk-return profile of PE strategies

Note: Data as of December 2016 - Vintages 2003-2013.
Source: Preqin.
To smooth the ‘J-curve effect’

During the initial phases of a private equity investment programme, an institutional investor will typically experience a period of negative returns, as a portfolio’s underlying fund managers draw capital for investment and management fees. This phenomenon is typically referred to as the ‘J-curve effect’. As Figure 3 shows, performance improves as a portfolio’s underlying investments benefit from value creation and the realisation of assets.

Secondary funds are able to offer institutional investors mitigation of the ‘J-curve effect’ by acquiring positions in mature (typically over five years old and >50% drawn) primary funds, 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.

To gain insight into individual GPs

Secondary funds can provide insight into primary market GPs with whom investors are considering a relationship – reducing the risks of making a first commitment ‘sight unseen’.

The diversification of secondary funds’ holdings gives their managers valuable insights into the strengths and weaknesses of primary market GPs. For this reason, secondary players often act as unofficial advisors to investors as the latter are constructing their private equity portfolios.

The private equity J-curve
Why investors sell assets in the secondary market

The recent growth of the secondary market is a natural consequence of the immense volume of private equity commitments made in the last decade.

Private equity is an inherently illiquid asset class. A private equity fund typically has a nominal life of 10 years – and the lives of funds have stretched well beyond this point since the global financial crisis (GFC). When LPs’ priorities and strategies change, as they inevitably do over time, the secondary market is the only way for them to gain an early exit from their commitments.

LPs have faced a number of specific challenges in recent years, both strategic and tactical (Figure 4).

**Strategic sellers**

Financial institutions have been the principal strategic sellers in recent years. Since the financial crisis, the pressures on financial institutions have been many and varied: all banks have had to contend with Basel III; US banks (especially) with the Volcker Rule; and European insurance companies with Solvency II; not to mention the regulatory demands of the G20 Financial Stability Board.

Banks in continental Europe were forced to shrink their balance sheets to compensate for sovereign debt write-downs; and publicly-owned banks in the UK and Ireland faced government-imposed asset disposals.

Nor have the pressures entirely gone away, despite the postponement of Volcker Rule deadlines and potential dilution of the Dodd-Frank legislation. In Europe in particular, regulators are still concerned about the robustness of the continental Europe banks, many of which have uncomfortably high levels of non-performing loans. As a result, the banking sector is likely to make further disposals of private equity-like assets (including CLOs and NPLs).

In recent years, mergers between large insurers have been a feature of the US market. This M&A activity, which results from the need to cut costs in response to rising liabilities, could also give rise to more asset sales, as institutions seek to rebalance merged portfolios or adjust their asset allocations.

The secondary market is continuing to respond to new liquidity needs

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Tactical sellers

After the global financial crisis, many private equity investors (especially pension funds, endowments and foundations, and various types of asset manager) found themselves with private equity portfolios created for a pre-crisis world. Many of these institutions have been tactical sellers, taking advantage of attractive secondaries pricing to rebalance their private equity portfolios – by vintage year, investment stage, investment type or geography (Figure 5). Many large investors have also used the market to concentrate their resources in a smaller core of high-quality managers.

GP-led liquidity transactions

Furthermore, liquidity transactions initiated by GPs (rather than LPs) are becoming an increasingly important segment of the secondary market (Figure 6). GP-led transactions are solutions in which a private equity manager works with a secondary specialist to offer liquidity options to its existing LPs, while securing additional time and funding to maximise the value of its unrealised portfolio. GP-led liquidity transactions represented 23% of secondaries investment by value in calendar year 2016.¹

Evolving market

Lastly, it is worth noting that the secondary market is still evolving rapidly. Private equity investments in real estate, natural resources and other real assets, infrastructure, and credit are increasingly coming to market.

It is estimated, for example, that approximately $4 billion of private equity real estate secondaries were transacted in 2016, and CalPERS alone sold approximately $3 billion of private equity real estate interests in the secondary market in 2015.

We expect secondaries sales to remain buoyant for a number of years as private equity investors continue reshaping their portfolios.

¹ Evercore.
Other market participants

Buyers

The universe of potential buyers for secondaries has expanded over the last decade as institutional investors have come to appreciate the advantages of secondary acquisitions. Buyers now have: varying levels of experience and expertise; different investment objectives; and different time horizons.

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

On the other hand, there are buyers who participate on an ad-hoc basis, for example, pension funds, banks, family offices, endowments and foundations, and even GPs. These non-traditional buyers are considered to be opportunistic investors in the secondary market. In general, they invest to take advantage of a specific opportunity, usually acquiring interests in funds through broadly intermediated processes.

Advisers

For many years, institutions wishing to obtain liquidity in the secondary market were obliged to run their own secondaries sale process. The limited resources available to many LPs, and their unfamiliarity with the processes involved, made this a daunting prospect.

As a result, intermediary firms identified an opportunity to offer secondary advisory services – including portfolio valuation, market research, and full M&A-style sell-side processes. These advisors are used mainly by LPs disposing of large 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, UBS, and Evercore.

General Partners

In the majority of secondaries transactions, GPs are ‘silent partners’. Rather than principals, they are facilitators and approvers of secondaries transactions.

GPs focus mainly on:

- control of data – sharing information on the fund(s)
- review and approval of potential purchasers
- response to due diligence enquiries during the later stages of the sale process
- completion of transfer documentation, to move ownership of the interest(s) from seller to buyer

In GP-led liquidity transactions, however, the GP plays a much more active part in the structuring of the solution. These transactions have several objectives: to provide a liquidity option to a fund’s original investors; to secure additional time, and potentially more funding, for a fund’s remaining assets; and to re-align the interests of new and remaining investors with those of the GP through some resetting of a fund’s terms and conditions.

Restructurings are inevitably complex, and present many challenges – not least in achieving a satisfactory alignment of interests between multiple parties. They tend to be highly bespoke transactions as a result.
Types of secondaries transaction

If private equity’s secondary market in its early days was largely a resale arena for LP fund positions, secondaries today comprise a far wider variety of transactions. (In addition to this section, see also the section headed ‘Current market environment’.)

LP secondaries – PE fund positions

This is the most common type of secondaries transaction, representing 71% of transactions in 2016.²

An LP secondaries 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 or funds in question (Figure 7). The replacement LP also assumes the original investor’s obligations to pay outstanding commitments to the underlying funds.

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 secondaries transaction involves the sale of a portfolio of direct investments into private companies – typically owned by financial institutions or corporations (Figure 8).

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

² Evercore.

Schematic overview of an LP secondaries transaction

Schematic overview of a direct secondaries transaction
‘Top-up’ capital infusion

In this type of transaction, private equity funds are bolstered by ‘top-up’ capital, which is used to provide capital infusions to the funds’ portfolio companies. The additional capital is injected into the original fund and there is no need to manage a separate fund (Figure 9).

This approach: removes the need for a GP to attempt a new fundraising at an unsuitable time; offers the original LPs the option to commit a certain amount of the ‘top-up’ capital; and may involve rebasing of a GP’s economics.

Tail-ends

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 and ‘lock-in’ their returns (Figure 10).

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

The number of secondaries transactions for private equity interests was relatively small until the mid-1990s, after which the market expanded consistently. Selling assets in the secondary market has now evolved into an attractive portfolio optimisation tool for long-term private equity investors.

In the early days of the market, prices paid by buyers often implied a significant discount to NAV. However, by the early 2000s, numerous specialist firms, funds-of-funds, and leading institutional investors such as endowments, foundations, and pension funds had started to engage with the secondary market – as investors, buyers and sellers. The additional demand did increase pricing, yet relative to the overall size of the primary market, secondaries sales were small, and pricing remained attractive enough to provide a considerable margin of safety.

The aftermath of the GFC resulted in a period of high volatility, but secondaries pricing has enjoyed a period of relative stability since the recovery of the market in 2010. Average prices at auction have risen from 83% of NAV in 2010 to 89% of NAV in 2016, with a peak recorded in 2014 (Figure 11). (Note that these are prices across all types of PE assets; pricing for buyout funds is higher, with average high-bid prices at auction reaching 96% of NAV in 2014.)

Several factors have combined to deliver this higher pricing: the gradual recovery in public equity markets; a good exit environment; the ready availability of debt; and strong fundraising by secondary managers. On the other hand, strong pricing has attracted a large number of sellers, which has acted to bring supply and demand back into closer alignment.

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 willing to ‘pay up’ for positions in funds they favour.

Outside these ‘plain vanilla’ situations, pricing varies more, and many 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; the complexity of a transaction.

We expect secondaries pricing to remain fairly stable in the medium term – although it is always possible that macro shocks will lead to wider discounts. (It is also worth noting that market dislocations typically create attractive investment opportunities for secondary buyers!)

### Average secondaries pricing as a % of NAV

![Figure 11](source: Greenhill)
Current market environment

Record market volumes

Private equity’s secondary market has experienced rapid growth in recent years, as institutional investors have taken an increasingly active approach to managing their alternative asset portfolios.

In the decade to 2016, LPs committed approximately $3.8 trillion to private equity globally. However, the onset of the GFC led to tighter regulations and new economic realities, prompting many LPs to seek early exits from their commitments via the secondary market. In consequence, the volume of secondaries transactions today (around $40 billion annually since 2014) is two-and-a-half times its pre-crisis peak in 2007.

Compared with the secondary market in quoted equities, the private equity secondary market is small, representing only around 1.4% of private equity’s total NAV. But in some senses, exact volumes are less important than the prospects and direction of the market – and these remain strong.

Financial institutions have been large-scale vendors of private equity assets over the past few years. However, the divergence in fortunes between US and European banks has become ever starker in recent times.

The US banking sector reacted relatively quickly to the financial crisis. US banks sold assets and restructured their balance sheets swiftly, and have fared better than their European counterparts as a result.

However, although American institutions sold large volumes of private equity assets, the regulatory direction of travel now looks likely to reverse: the Volcker Rule deadlines have been postponed again, and the current administration is talking seriously about a dilution of the Dodd-Frank regulators.

Although European banks have also shrunk their balance sheets, the authorities remain concerned about their robustness, especially because a number of them have uncomfortably large holdings of non-performing loans. European regulators are therefore likely to require further disposals of private equity-like assets (including CLOs and NPLs).

The rise of GP-led liquidity solutions

Although a significant amount of private equity’s current NAV will be realised in the normal way, another sizable portion will prove challenging for GPs to exit within a sensible time-frame. This is particularly true for funds where the evolution of portfolio companies was delayed or badly damaged by the recession.

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References:

3 Thomson Reuters.
4 Coller Capital.
Delayed exits give rise to another important market dynamic: a weakening of LP/GP alignment in ageing private equity funds. Where they have little prospect of carried interest or are unable to raise another fund, GPs may be reluctant to exit investments because this effectively puts them out of business.

Over $300 billion of assets is still held in pre-2007 vintage funds, according to Thomson Reuters, whereas funds raised since 2007 hold $1.4 trillion of NAV. A significant proportion of this total value is in funds near the end of their lives (Figure 12).

Because of these issues, LPs and GPs alike have been increasingly willing to see existing private equity vehicles restructured, or (in the case of viable GPs) exited en bloc, in asset disposals/tail-end sales. Such transactions tend to be initiated and led by GPs, with the active involvement of secondary buyers.

Given their complexity to structure and execute – and the appetite and commitment needed on all sides – many mooted transactions of this sort never actually get off the ground. They typically entail lengthy discussions with the existing LP base and/or members of the LP Advisory Committee, and can often require a 75% or higher LP approval threshold. For bidders, a major challenge is therefore the uncertainty as to whether a transaction will eventually result.

Nonetheless, $8-9 billion of GP-led liquidity transactions was completed in 2016 – some 23% of overall market volume, and an increase on the 13% recorded in 2015. Intermediaries believe this level is likely to be maintained or surpassed in the years ahead.

Real assets secondaries

Real assets transactions have become increasingly common in the secondary market in recent years as fund investors have increased their allocations to these areas. In 2014-15 nearly 70% of LPs were invested in energy-focused private equity, and 52% of LPs in private equity real estate (Figure 13).

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

It is estimated, for example, that around $4 billion of private equity real estate secondaries alone was transacted in 2016. Sellers have tended to be predominantly North American, reflecting the relative maturity of the US primary real estate market.

In the long term these transactions are expected to become increasingly frequent as the secondary market continues to evolve and mature.

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5 Thomson Reuters One as of 31 December 2016.
6 Greenhill / Lazard.

LPs with current / planned private equity exposure to real assets

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Coller Capital: a track record of closing complex transactions

Coller Capital is a leading player in private equity ‘secondaries’, acquiring positions in private equity funds from Limited Partners and portfolios of unquoted companies from corporate or institutional owners. These are a few examples of Coller Capital secondaries transactions:

**CVC Capital 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.

**Irving Place Capital**

*July 2015*

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

**American Capital**

*May 2014*

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

**ABS A**

*December 2013*

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

**Lloyds Banking Group**

*August 2012*

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

**Crédit Agricole**

*December 2011*

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

**Monte dei Paschi di Siena**

*September 2014*

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

**SVG Capital**

*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.

**SVG Capital plc**

*June 2008*

Acquisition of a direct venture asset portfolio of 18 companies from the quoted investment vehicle Prelude Trust.

**ICICI Venture**

*January 2006*

Investment in ICICI Venture’s India Advantage Fund I. This was India’s first secondaries transaction.

**Royal Dutch Shell**

*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.

**AABBYY**

*September 2004*

Purchase of a portfolio of companies from AABYY, with management team spin-out.

**Dresdner Kleinwort Benson**

*September 2004*

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

**Lucent / Bell Labs**

*December 2001*

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

**AEA Technology**

*September 2005*

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

**RBS / NatWest**

*June 2000*

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