How to Navigate a Growing Secondaries Market

March 2024

Investing in secondaries can be a beneficial way to access the private markets, occasionally at a discount. Yet, as the market is seeing rapid evolution with new entrants, there could be more specialization amongst the distinct types of secondary funds. So, is there a way to navigate this? Recognizing the traits across both GP- and LP-led secondary categories is a crucial part of determining potential returns and incorporating these funds within a portfolio.

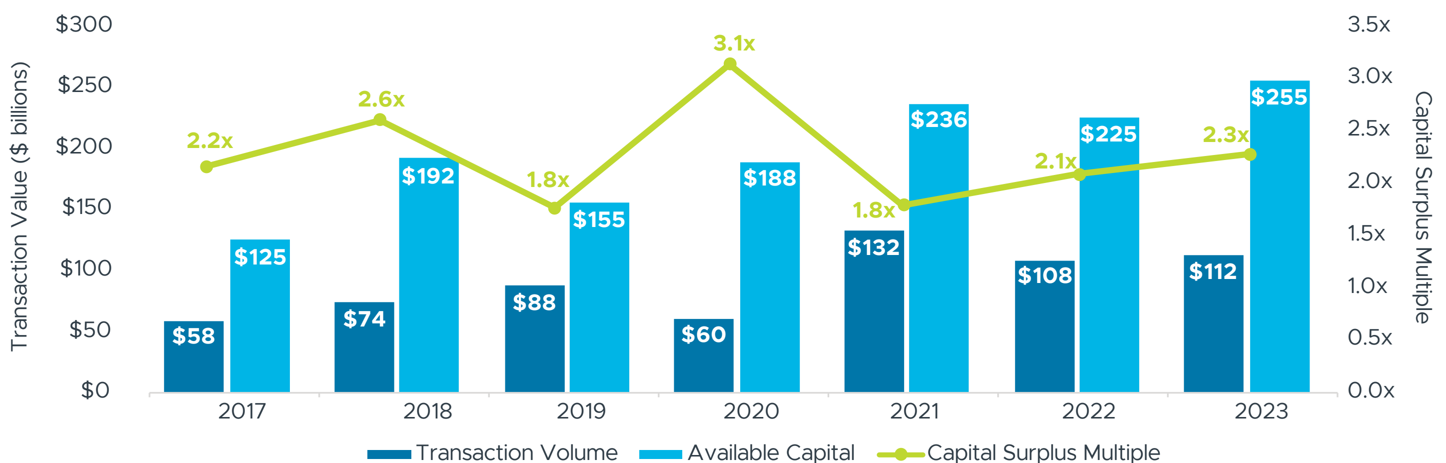
Secondary funds are an appealing pathway to invest in the private markets. The last three years alone have seen record transaction volumes, with each year eclipsing $100 billion. And all signs point to more activity ahead. Dedicated available capital has doubled over the last six years to over $250 billion, or 2.3x transaction volume in 2023, pointing to sufficient amounts of dry powder (Exhibit 1). And several major asset managers are expanding their secondaries business with strategies to grow their presence in the private wealth channel, highlighting a broader appeal of the asset class.

The momentum in the secondaries market – particularly for private equity – has been building for two main reasons: 1) the abundant growth in the primary private equity market; and 2) limited partners (LPs) who are seeking liquidity, or a need for cash. Over the last 10 years, the primary private equity market has almost tripled to about $6 trillion in assets, meaning there's a tremendous amount of "inventory" owned by private equity funds.[1] On occasion, investors need liquidity before the end of a fund's term. When confronted with a slow exit environment, LP investors may take it upon themselves to sell their interests via the secondaries market.

There are many other aspects to the secondary markets. LPs may sell their private market interests in effort to strategically realign their portfolio. Often, this is in response to changes in the LP's overall portfolio composition. For example, if public equities experience a material change in value, an LP might need to sell private holdings so the portfolio doesn't breach allocation guidelines; otherwise known as the "denominator effect." And general partners (GPs), who manage the primary funds, can also feel pressure to generate liquidity in order to return cash to its LPs.

Exhibit 1: Recent Years Have Seen Record Secondaries Transactions and Available Capital

Annual Secondaries Transaction Volume and Available Capital



Source: Jefferies, Global Secondary Market Review, January 2024. Available capital defined as the sum of equity dry powder, near-term fundraising, and near-term available leverage. Leverage estimated as approximately 15% of equity dry powder plus near-term fundraising. Capital surplus multiple defined as available capital divided by transaction volume. For illustrative purposes. Past performance is not indicative of future results. Future results are not guaranteed.

The sustained size of secondary deal activity has arguably now established secondaries as a core aspect in how private markets function. So much so that GPs and LPs are using the market, and related products such as continuation funds and NAV loans, to finance deals.

- A continuation fund is a newly formed fund, created and then managed by the initial fund GP, to which certain portfolio assets are sold or transferred. A continuation fund is typically considered when a GP is unable to "exit" an asset, or the fund is at the end of its life.

- A NAV loan initiated by a GP which is secured by underlying assets in the portfolio. A NAV loan could be utilized to distribute capital to LPs in certain market environments.

EXPLORING THE ATTRIBUTES OF PRIMARY VERSUS SECONDARY FUNDS

These recent industry advancements have led to many different fund options for those that want to invest in private equity. Determining the suitability of a primary versus secondary fund is a starting point. Then the major types of secondary funds can be explored, followed by looking at approaches to bring these categories into a portfolio.

For investors that are new to private markets, secondary funds can be a path to gain access to private equity. Both primary and secondary private equity funds have a role in the alternative investment universe, but they have material differences. One difference is diversification. Investors in secondary funds can gain exposure across several managers, strategies, vintage years, and geographies. Another difference is faster capital deployment. Managers of primary private equity funds can take years to source and complete deals, which means it can take several years before investors start receiving distributions. Secondary funds, on the other hand, typically invest in underlying funds that are at least in their third to fifth year of life, providing faster capital deployment. This mitigates the private equity J-curve.

Discounts are also a significant factor and can provide a margin of comfort for investors. LPs that are sellers with a secondary transaction may need to offer their assets at a discount, or below net asset value (NAV). As such, secondary fund managers can buy these assets for less than what they might be worth. In essence, investors in secondary funds can receive a boost from the markup of discounted purchases upon transaction, which can act as an enhancement to overall return.

Pricing varies and discounts may not always hold true. But the trendline has been in investors' favor. Since 2017, LPs have sold assets at an average of 88% of NAV.[2] Even when markets are robust with healthy deal activity, LPs have settled for a discount. In 2021, for example, average LP secondary market pricing was 92% of NAV.[3] The sustained period of discounts could be a sign of a mismatch in seller-buyer deal volumes, indicating deals are getting done at

Exhibit 2: Private Equity: Primary Versus Secondary Funds

	Primary Fund	Secondary Fund
Diversification	Typically focused on a single strategy (e.g., buyout) with concentrated holdings.	Often diversified across managers, industries, geographies, strategies, and vintage years.
Capital Deployment	Capital deployment typically takes three to five years.	Typically, capital deployment is faster and distributions begin earlier in the fund's lifecycle - in some cases as soon as the fund's inception.
Liquidity	Both primary and secondary investments are generally considered longer-term investments. Shorter duration and earlier distributions (due to more mature underlying assets) typically provide additional liquidity benefits for secondary funds.	

Source: iCapital, as of March 2024. Reflects characteristics of traditional private equity funds made available to Qualified Purchasers. For illustrative purposes only.

what sellers are willing to accept rather than buyers are willing to pay. Finding these discount opportunities can be a sizable benefit for secondary fund investors.

Investors should also be aware of other considerations. Some secondary funds may focus on acquiring assets at a later stage, which means they may not capture the initial value creation initiatives of investments from the underlying GPs. Other secondary funds may focus earlier on in the life cycle to gain exposure to more growth uplift. However, both strategies typically have exposure to value creation uplift—it just might be captured at a different stage.

When evaluating secondary funds, deal sourcing is important and managers that have access to a broad platform (e.g., primaries, co-investment platforms) can often benefit. As with any private equity investment, manager selection is critical to realize the benefits of these strategies.

TYPES OF SECONDARIES

For secondary funds, there are also different ways in which a transaction is initiated, otherwise referred to as LP- or GP-led.

- **LP-led secondary transactions:** The most traditional type of secondary has been the LP-led transaction, where an LP in a fund seeks an early exit and sells its interests. Buyers are typically other existing LPs in the fund, new investors, or dedicated secondary funds.

- **GP-led secondary transactions:** GP-led transactions gained more prominence in recent years when fund managers were searching for alternate options to manage their portfolios. These transactions involve a GP transferring a single or a few companies to a new investment fund (a continuation fund). In a GP-led secondary transaction, the current LPs of the original fund are given the option to cash out or roll over their interests into a new vehicle, which typically also admits new LPs. This effectively extends the timeline the GP owns the interests, allowing more time for asset appreciation.

How does this all factor into the different secondary fund product options? Most secondary fund managers invest across both transaction types, with a balanced or opportunistic approach. But some funds may seek a more weighted approach: an 80/20 allocation between LP - and GP-led secondaries, for example.

For investors, the allocation might be a key factor. LP-led portfolios are likely to start distributing capital faster because there are so many companies in various stages of maturity. This speed of capital distributions in addition to the boost received from mark-ups of discounts, can result in generally favorable returns for LP-led portfolios. Looking at just one measure, a 2023 global survey suggests net target multiple on invested capital (MOIC) of LP-led secondary funds ranged between 1.6x and 1.7x.[4] On the other hand, the selectivity and concentration of GP-led portfolios can put them higher on the risk spectrum, but also positions them for higher potential returns. Here, net target MOIC for single and multi-asset GP-led transactions ranged between 2.0x and 2.2x in 2023.[5]

How a secondary fund invests across these transaction types is just one factor and should be considered alongside the overall investment strategy, manager selection and even the relationships the secondary fund has with GPs.

INCORPORATING SECONDARY FUNDS IN A PORTFOLIO

Incorporating secondaries into a portfolio can be a valuable risk-mitigating tool by reducing the J-curve effect, typically generating a faster distribution pace and return of capital, and reducing blind pool risk at the asset level.

For investors seeking to gain private equity exposure but are concerned about the duration or significant gap between making a commitment and receiving distributions, a secondary fund can be an appealing option. Of course when incorporating private investments in a portfolio, liquidity and risk tolerance also need to be considered. Finding the right balance between higher upside and liquidity needs is different for each investor's situation, but can be an acceptable trade-off for many investors who do not need 100% daily liquidity.

IN CLOSING

For investors that are ready to access private equity, secondary funds are a pathway that offers several unique portfolio benefits such as liquidity generation or J-curve mitigation. Although secondaries generally share similar characteristics, each fund has a different approach to portfolio construction. Recognizing these unique attributes will help in establishing baseline risk/return expectations to better incorporate private equity exposure within a portfolio.

ENDNOTES

1. Preqin, “State of the Market, H1 2024,” Jan. 2024.
2. Jefferies, “Global Secondary Market Review,” Jan. 2024.
3. Jefferies, “Global Secondary Market Review,” Jan. 2024.
4. Lazard, “Secondary Market Report 2023,” Feb. 2024.
5. Lazard, “Secondary Market Report 2023,” Feb. 2024.

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