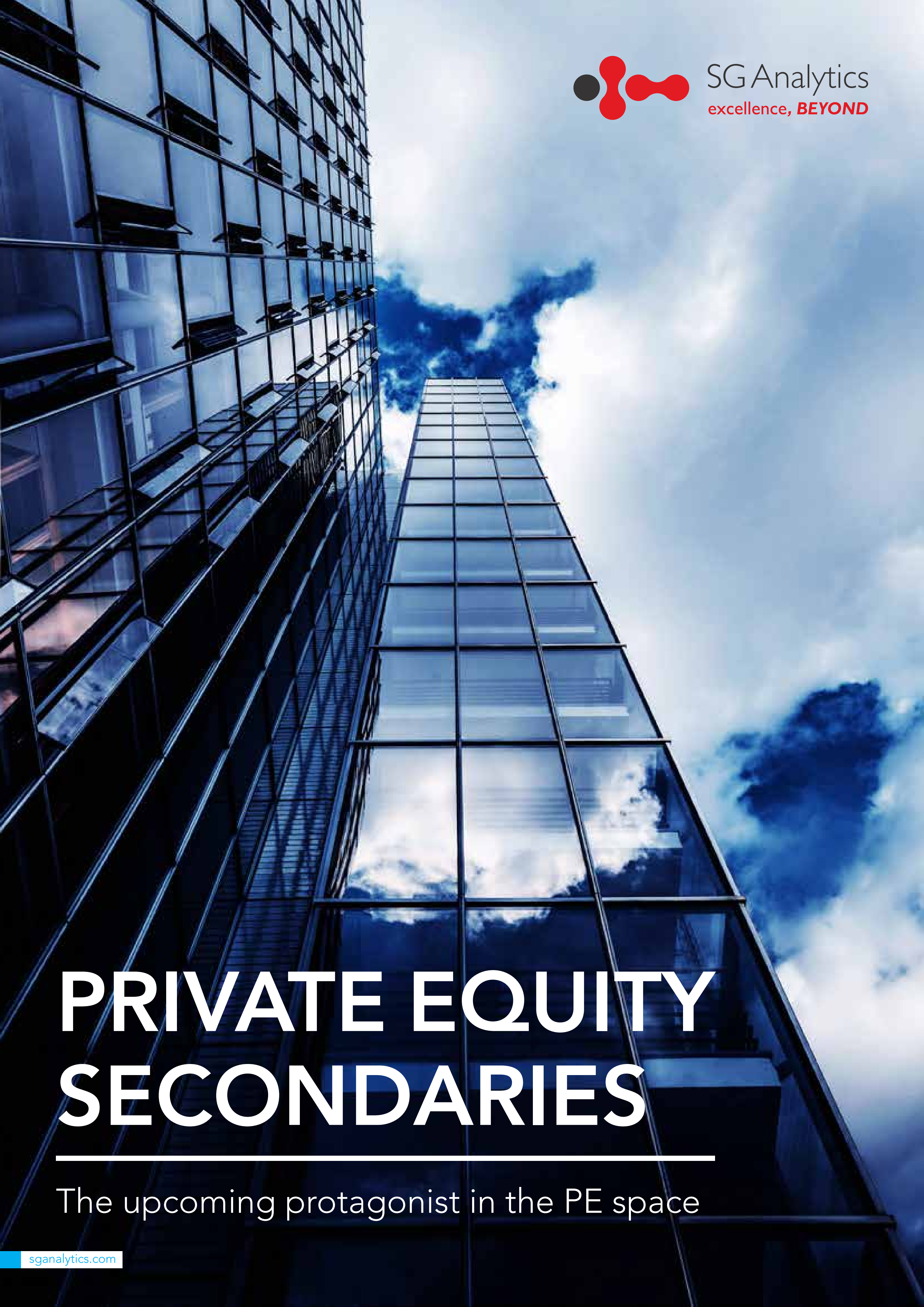

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PRIVATE EQUITY SECONDARIES

The upcoming protagonist in the PE space

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For several years, private equity (PE) has been an excellent source of capital for companies in various stages of the business lifecycle; be it unlisted companies in their growth phase, distressed companies looking for capital, or mature companies with steady cashflows wanting to raise funds for expansion capex. However, PE investments are inherently long-term in nature, and it could take several years for a fund to achieve the intended results. To solve this precise lack of entry and/or exit for both prospective buyers and sellers, capital markets have found a solution – PE secondaries. While liquidity was the main reason why the PE secondaries market came into existence, there are several other important factors helping this market flourish today, albeit peppered with some challenges.

Read on.

CONTENTS

1. PE secondaries – the time is now

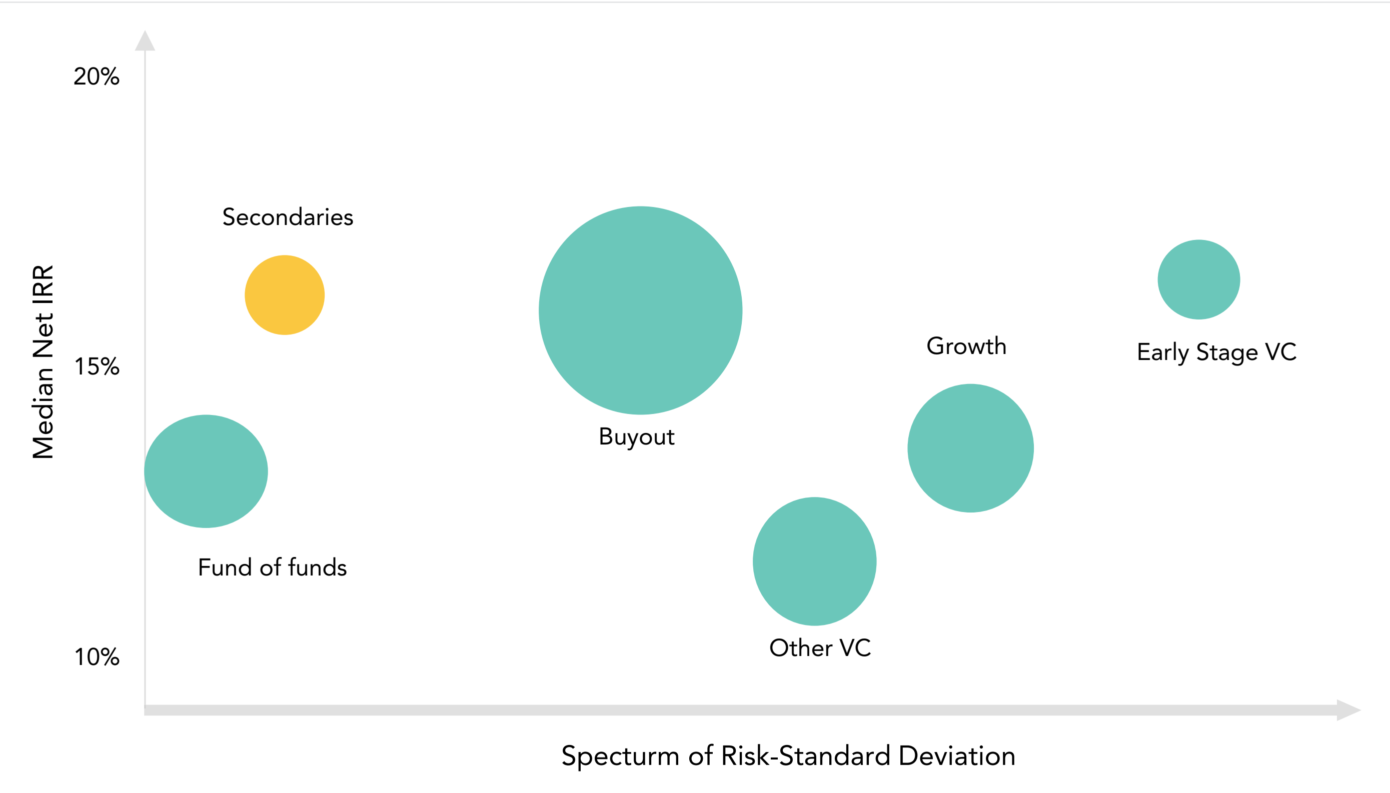
The investor community, from retail to institutional, is spoilt for choice – public capital markets, real estate, natural resources, venture capital, derivatives, distressed assets, cryptos, etc. Among various selection criteria in choosing investments, timing is arguably the most crucial for investors. A missed opportunity might take several years to show up again (or may be not). Through this whitepaper, we explore a mechanism that is gaining a lot of momentum lately, as it gives sellers an exit option and investors a repeat opportunity. We put the searchlight on the PE secondaries, a fast developing but not so young market (been around since the 1980s).

Before we delve into the nuances of PE secondaries, let us explore what makes it one of the most exciting investment routes.

As we are aware, PE as an asset class has outpaced most other prominent asset classes, including the public markets (excluding crypto currencies, which are highly volatile and have various questions surrounding them at present). According to a report by McKinsey (A year of disruption in the private markets, April 2021), the PE market delivered 14.3% annualized return over 2010–2020, compared to 13.8% for the S&P 500 Index. When compared over two decades from 2000 to 2020, the outperformance is even higher (PE: +9.9%, S&P 500 Index: +6.4%).

Within this high-performing PE universe, secondaries have the most attractive risk-return profile. Exhibit 1 explains why 'Secondaries' are a highly compelling proposition within the PE space. In 2020, secondaries contributed just 5.2% of the total PE deal volumes. Considering the market dynamics, overall PE deal volumes are slated to go northward in the long-term, implying a significant scope for PE secondaries to gain a larger foothold in the PE universe.

Exhibit 1: Secondaries have the best risk-adjusted return (reflects vintage years 2007-2016)



Source: 2020 Preqin Global Private Equity & Venture Capital Report, Adams Street Partners, SGA
Note: Size of the circle indicates capitalization across all funds

2. An introduction to secondaries transactions

The PE secondaries market offers a transaction mechanism where a Limited Partner (LP), or the seller, in a PE fund sells its interest to another investor, mostly a specialist in the PE secondaries space (there are over 100 investors in the secondaries market). Broadly, there are two types of transactions in the secondaries space: (i) sale of fund interests and (ii) sale of direct interests. The most straightforward transaction is when LPs sell their position to another interested party to generate early liquidity instead of waiting until the end of the fund's life.

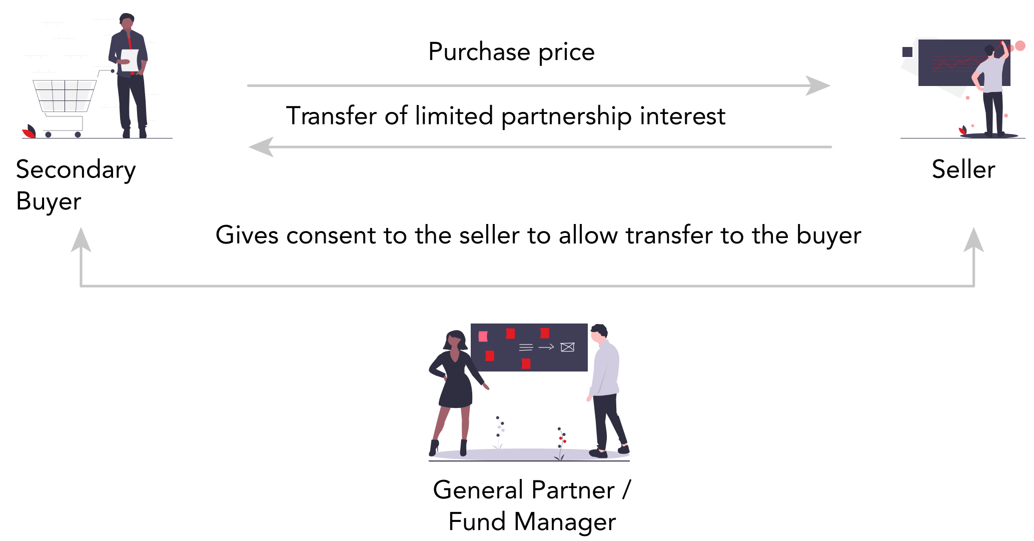
2.1 Sale of fund interests

The sale of fund interests involves selling of stakes by an LP to a prospective buyer with the consent of the General Partner (GP), i.e. the fund manager. This provides liquidity to the seller and releases them from any unfunded commitments. In these transactions, an existing owner sells the rights and obligations to a new buyer who does not have any existing investment in the fund.

2.2 Direct secondaries transactions

The sale of direct interests, or synthetics, involves the sale of portfolios of investments in operating companies to a buyer, rather than the LP's interest in a fund. The motives behind direct secondaries transactions are no different from the former. In a direct transaction, LPs sell their stakes to an existing investor and not to a new a buyer. The most common direct transaction is when a GP buys the stake of an LP or an existing GP.

Exhibit 2: PE secondaries transaction



Source: SGA, Capital Dynamics

With reference to Exhibit 2, in sale of fund interests, the 'Secondary Buyer' is the new player who wants to own a position in the fund. In case of a direct transaction, the buyer would be an existing stakeholder. It is worth noting that due to the sophisticated nature of secondaries, there could be many sub-types of these transactions.

One of the key catalysts in the growth of PE secondaries is the GP-led transactions, which were only 7% of the total transactions in 2013 but have grown to 44% in 2020. In these transactions, GPs help existing LPs to find and sell their positions in the secondaries market to increase liquidity and goodwill for the fund.

3. What is in it for the sellers, i.e., LPs?

In general, the LPs (pension funds, endowment funds, sovereign wealth funds, etc.) of PE funds stay invested until the fund is closed after the liquidation of its investments. The PE secondaries market provides the much-needed liquidity in this otherwise 'buy and hold' market. It would not be an exaggeration to state that liquidity is the raison d'être for the existence of the PE secondaries market. The main function of the PE secondaries market is akin to that of the public secondary markets: to provide a platform for exchanging securities between interested buyers and sellers. To exit from any PE fund or relationship with a GP, LPs simply sell that part of their stake in the fund which has not yet matured.

Although liquidity is the most prominent motivation behind secondaries' transactions, the following reasons at times are equally, if not more, important.

1. Reduce the number of GPs: LPs sell their stake in non-strategic funds to reduce the number of GPs for simplifying portfolio administration.
2. Lock returns on profitable investments: Profit booking is a key motivation, where existing stakeholders think the upside potential is limited or long drawn.
3. Modify exposure due to regulation: New regulatory regimes are also a driver for secondaries transactions. For example, banks and insurance companies need to follow the Basel and Solvency norms, which has prompted significant selling by these participants in the past few years.
4. Change in asset allocation strategy: Rebalancing the portfolio quickly to take new positions or sell existing positions according to the portfolio mandate, shift the sector/region focus, etc.

4. What attracts buyers to this market?

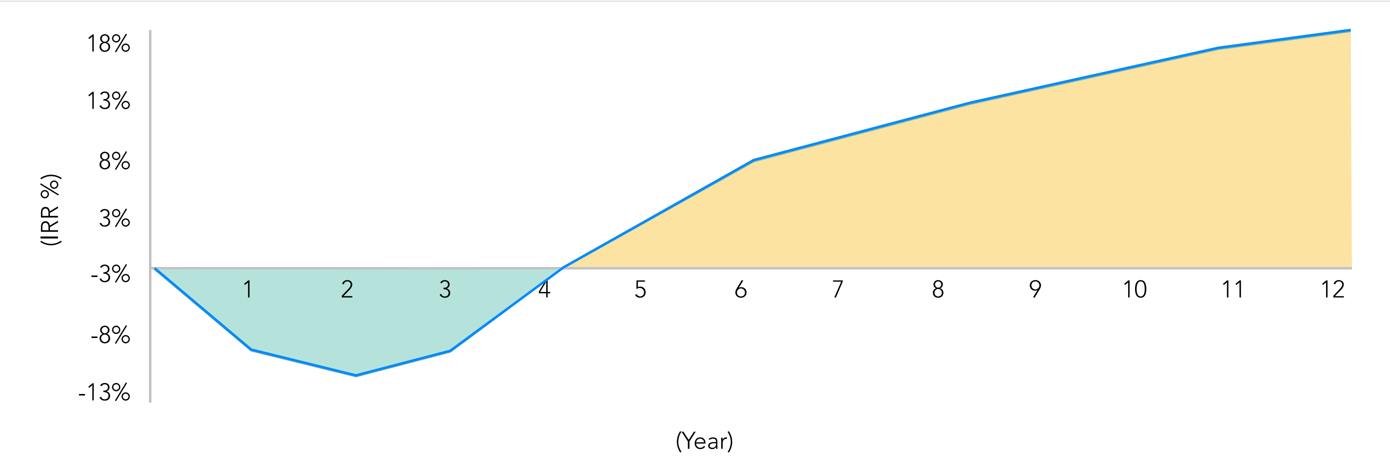
As mentioned before, the investment horizons for PE investments are significantly longer than the ones in public markets. Hence, some of the existing investors try to exit before maturity. This provides an opportunity for secondary buyers to acquire stake at a favourable price – on most occasions. In addition, the secondaries market allows the buyer to evaluate the holdings or portfolio of the target fund before acquiring a stake in the fund. Thus, secondary buyers can make an informed decision, keeping in mind the investment period of the fund, sectoral or regional exposure, etc.

There could be several possible reasons for an investor to acquire stake in PE funds via secondaries:

4.1 Avoiding the J-Curve

Typically, it can take three to seven years from the initial fundraising before PE investors start receiving profit distributions. These long investment periods make PE investments illiquid by design. Hence, it is difficult to buy and sell positions in PE investments.

Exhibit 3: Typical return pattern of PE funds



Source: SGA, Pomona Investment Fund

The J-Curve in Exhibit 3 depicts the typical journey of PE funds where they face negative returns and cash drags in early years (investment costs, management fees, early-stage investments, write-offs, etc.). After the formative years, returns get positive and accelerate with time as the investments mature.

Secondaries provide a platform to deploy capital faster. Profit distribution begins relatively quicker as investors enter the fund after the period of negative returns is over. This helps the purchasers of equity secondaries to avoid the J-Curve. It might seem counterintuitive to think that an LP would like to exit a position that has turned green and set to provide accelerated return. However, realistically, the motivation of sale (liquidity, portfolio rebalancing, etc.) and the 'relief from the red' syndrome can sometimes outweigh the promise of future returns. The financial markets are, at the end of the day, driven by the 'greater fool theory'.

4.2 Discounted access to PE funds

The secondaries market has been a buyer's market for most part of its existence, which is reflected in the spread between the fund's net asset value (NAV) and the sale price. Given that the secondaries market offers a much-needed exit option for LPs who were early investors, the stakes in the secondaries market are sold at a discount to the fund's NAV. According to data from Greenhill Advisory, secondaries portfolios traded at an average of 86% of the fund's NAV during 2011–2020, compared to 108% and 109% in 2006 and 2007, respectively (Exhibit 6). That said, the discount has narrowed over time as the market has grown well in recent years and has become more competitive with the entry of diverse, sophisticated players such as pension funds (particularly large Canadian pension funds), sovereign wealth funds, family offices, endowments, and so on.

The discount (or at times premium) is completely dependent upon the supply–demand balance of the market. Discounts can reduce significantly – or even turn into premium – if the market heats up, just like it did before the global financial crisis (GFC). Discounts sharply increased in 1H20 due to the COVID-19-induced market volatility, but partially recovered in 2H20.

5. Impact of COVID-19 on PE secondaries

The COVID-19 pandemic and concomitant lockdowns in most major markets had a significant impact on the overall financial markets. The PE secondaries market was not spared either and transaction volumes declined significantly. According to Greenhill Advisory, secondaries' trade volumes dropped as much as 57% YoY in 1H20 to $18bn, with the average price for all transactions down 800bps (vs. 2019) to 80% of NAV. Volumes declined as both buyers and sellers waited on the side-lines to get a clearer picture of price expectations and underlying portfolio revaluations amid the apparent economic weakness. Although some investors took aggressive bets, most others remained conservative. In addition, there was apprehension and uncertainty related to the fair value of funds and secondaries' pricings.

Today, the overall market dynamics seem to be improving, led by worldwide vaccination programs coupled with dovish monetary policies by central banks across the globe. Buyers are seeking attractive opportunities and sellers are stressed for liquidity, looking for an exit. In 2H20, secondaries' volume witnessed a sharp recovery to $42bn, registering a 133% HoH led by GP-related transactions (>50% of total volume). According to Evercore, most of the transactions were done by top players and the secondaries were top-heavy last year: buyers with funds of $5bn or more accounted for almost half of the total volumes.

Exhibit 4: Secondaries volume ($ bn)

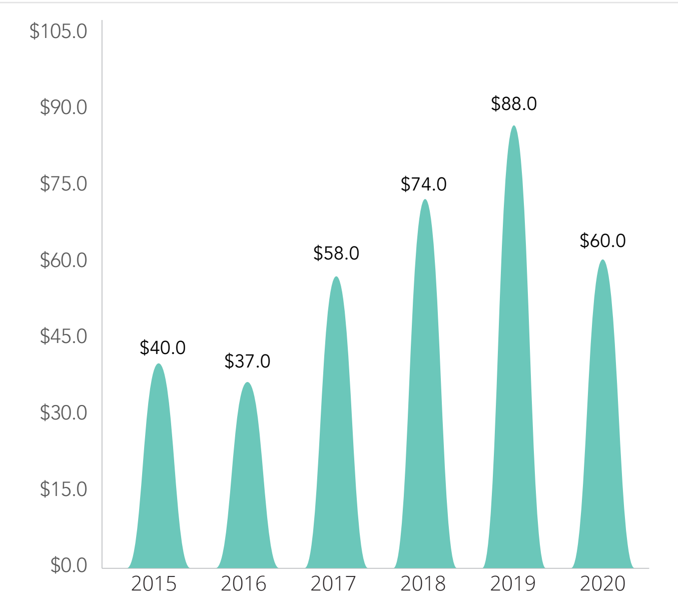
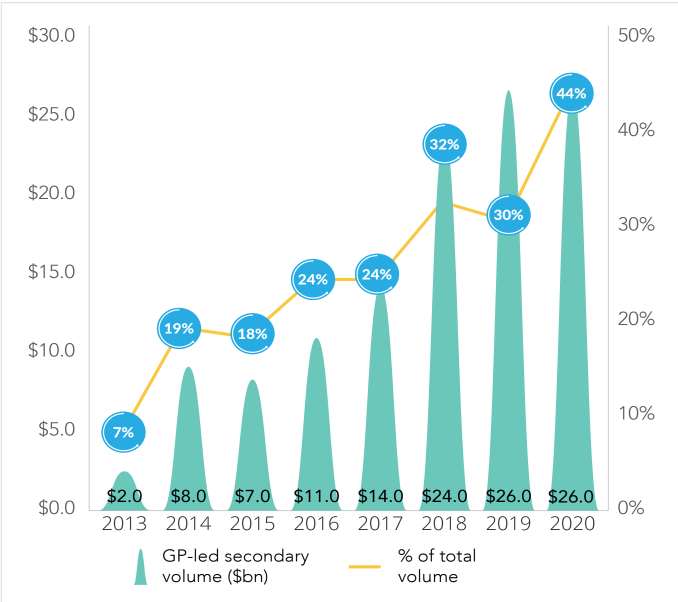


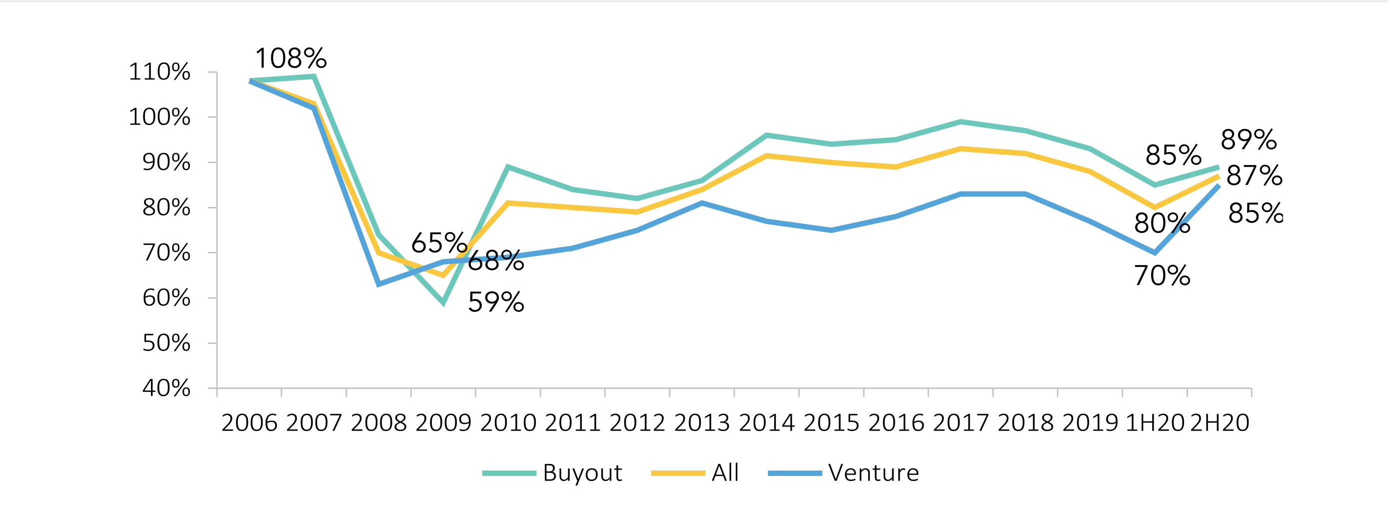
Exhibit 5: GP-led secondaries volume ($ bn)



Source: Greenhill - Global Secondary Market Review (Jan 2021)

Another important factor that aided volume recovery in 2H20 was the attractive pricing levels of the PE secondaries market. Pre-pandemic, the PE secondaries market was priced at relatively higher levels – in some cases at 100% of NAV – which made it less attractive for buyers. However, the COVID-19-induced downturn paved way for lucrative pricing and enabled buyers to take positions, aiding volumes.

Exhibit 6: Historical secondaries pricing as a % of NAV



Source: Greenhill - Global Secondary Market Review (Jan 2021)

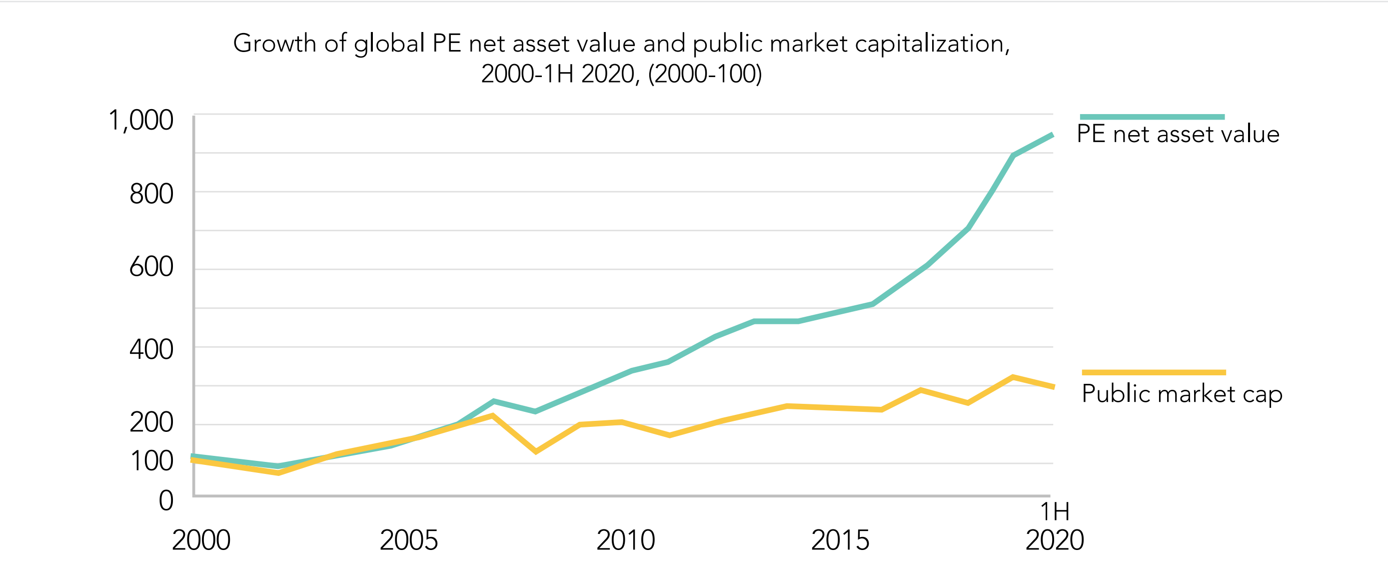
Looking ahead, industry research suggests that volumes might remain stable at best for the next six to eight quarters, as global economic activity gradually inches toward pre-pandemic levels. However, the bid-ask spread is expected to remain high for a few more quarters before adjusting to normal levels, as witnessed in other periods of volatility such as the GFC.

6. At an inflection point: opportunities and challenges galore

6.1 A strong underlying market

The overall NAV of PE funds and the market capitalization for listed companies were moving in tandem until 2008, until when the GFC hit the world. Post the GFC, the NAV for PEs outpaced the growth in market capitalization of public companies. Currently, the global NAV for PEs is almost thrice ($4.5tn at the end of 1H20) that of the public market capitalization. The growth in PEs shows what is in store for the secondaries market, which should register at least similar – if not faster – growth.

Exhibit 7: PE NAV outpaced the total market cap of listed companies* since the GFC



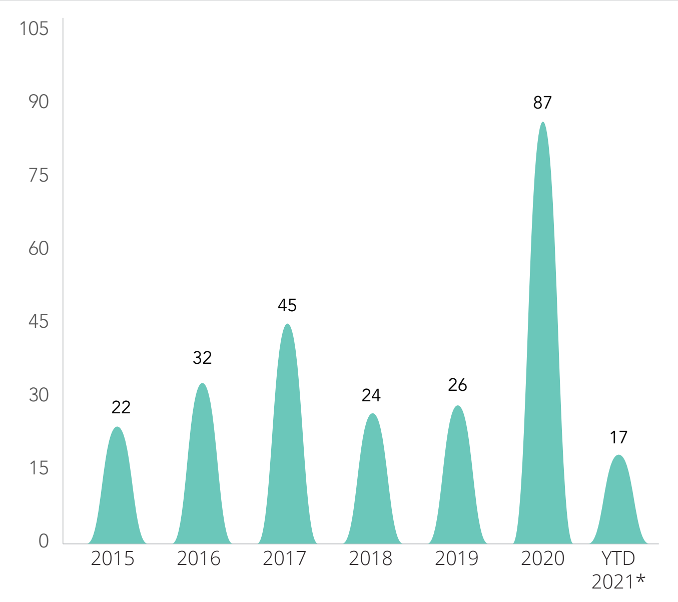
Source: World Federation of Exchange, Preqin
**Note: Net asset value equals asset under management less dry powder. Market cap is based on the market cap of companies globally.*

6.2 Ongoing pricing attractiveness

As mentioned earlier, the economic upheaval after the COVID-19 pandemic might take a few more quarters. There are various firms who are under significant stress and will need external funds to get through. At present, this is a buyer's market with stressed investments available at a discounted price that could provide significantly higher returns in future. Although demand for PE secondaries picked up in 2H20, prices recovered only partially (Exhibit 6). Given that pricing remains attractive and well below the pre-pandemic levels, this should continue to attract volumes in the PE secondaries market.

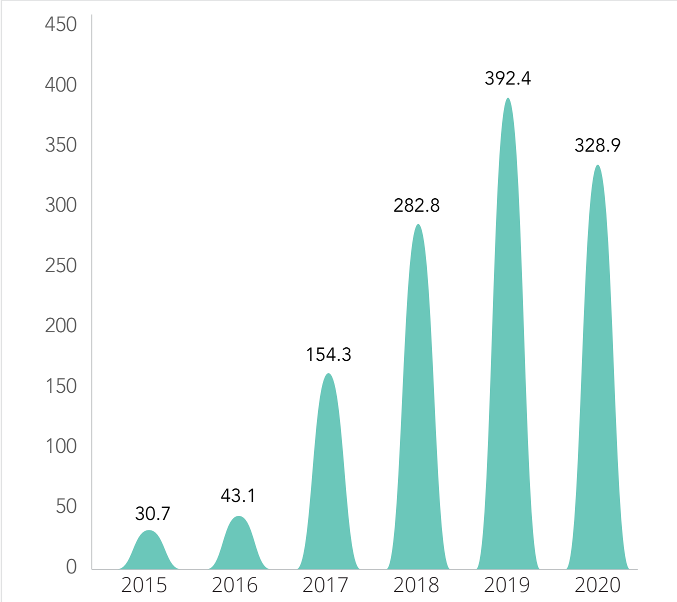
6.3 Strong supply of dry powder

Exhibit 8: PE secondaries fundraising ($bn)



Source: Preqin, McKinsey, SGA

Exhibit 9: PE dry powder by vintage year ($bn)



Source: McKinsey, Pitchbook, SGA

Exhibit 8 shows that fundraising for PE secondaries activities increased 238% YoY to $87bn in 2020. Juxtaposing this with transaction volumes – which reached barely $60bn during 2020 – implies that most PE funds have significant dry powder (Exhibit 9) to quickly seize lucrative opportunities. Industry estimates suggest that secondaries' investors had around $113bn unspent capital as of 31 December 2020. The transaction backlog induced due to the pandemic should be recovered during the upcoming quarters, and volumes could also be aided by the ongoing global availability of cheap debt (for instance, US 10-year bond yield is at ~1.6% currently compared to the pre-COVID levels of ~2.5%). In addition, during the GFC in 2008, many LPs pulled back from private asset classes and ended up missing out on much of the recovery. This time, most LPs seem to have learned from the past, as investor appetite for PE appears relatively undiminished following the turbulence last year.

6.4 Challenges

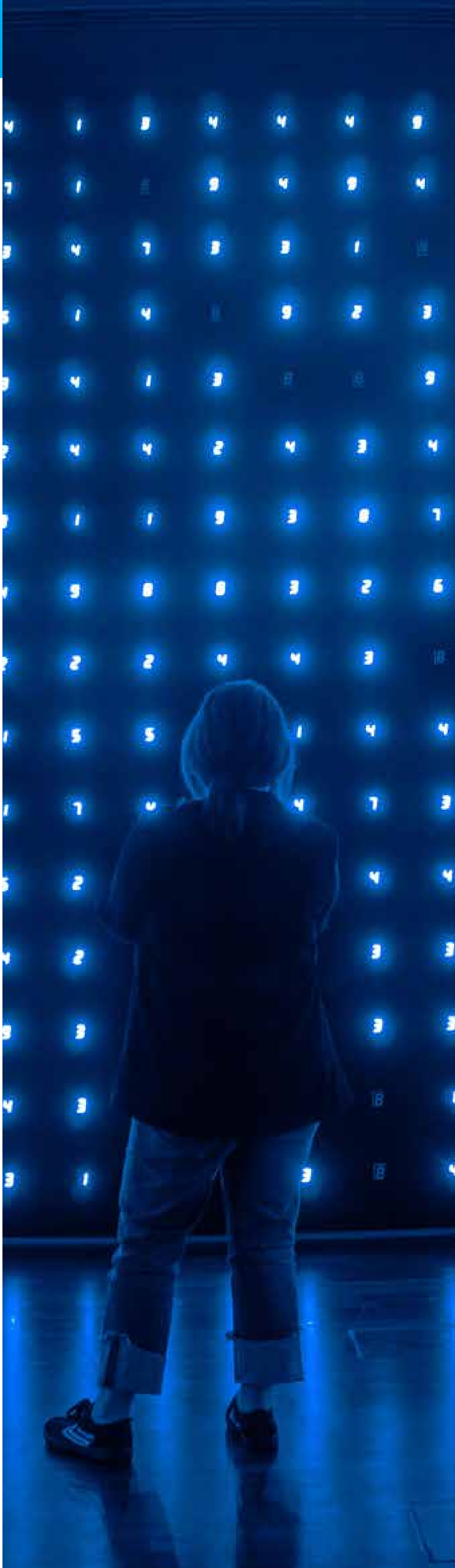
Although the overall market dynamics are quite favourable for PE secondaries, there are a few challenges, albeit short-term, that exist. For instance, the deals involving tail-end investments may face difficulty in finding buyers at a reasonable price since the valuations of such assets are dependent on the seller's ability. Thus, it will be challenging to price such a portfolio in comparison to a portfolio having unfunded commitment or early-stage investments. Diversified fund portfolios will be the most impacted as buyers would find it difficult to effectively price a bouquet of assets in this volatile period.

7. Whither go secondaries?

PE secondaries transactions have now become a proven instrument to actively manage PE portfolios. According to a 2020 report by Cambridge Associates, "secondaries are no longer relegated to the kids' table." Active participation of private fund managers has made it a potent tool for strategic realignment of investors' funds, going beyond the primitive objective of liquidity. The lay of the land for secondaries is changing and the market's ecosystem has also developed significantly in the recent past. For instance, various secondaries advisory firms are now available to help price portfolios, identify buyers and sellers, structure transactions, manage data rooms and NDAs, and collect and negotiate offers that aid the decision-making process to a great extent.

The biggest driver for the secondaries market has been the stellar growth in the overall PE space since the GFC. The current scenario is challenging for PEs in terms of both pricing and volumes. However, most of these hurdles are short-term and most likely to last for a year or so. The long-term story is still intact and appears attractive. One of the major challenges faced by the PE space is valuation of underlying assets in this time of uncertainty, as the 'private' nature of these assets implies scantly available information. As such, although most investors believe that these assets may face markdowns, they are unsure of the magnitude of corrections.

The amount of cumulative dry powder has been increasing since the outbreak of the COVID-19 pandemic, which should help secondaries remain one of the fastest-growing parts of the PE space. Once the pandemic situation ebbs, one can except to see heightened action in secondaries. The transaction volumes should witness a significant surge, driven by buying of marked-down assets, release of pent-up demand, higher GP-led transactions, and FOMO (fear of missing out) good opportunities. According to Tom Kerr, Head of Secondaries at Hamilton Lane Inc., "…2021 is going to be a record year for secondary deals."

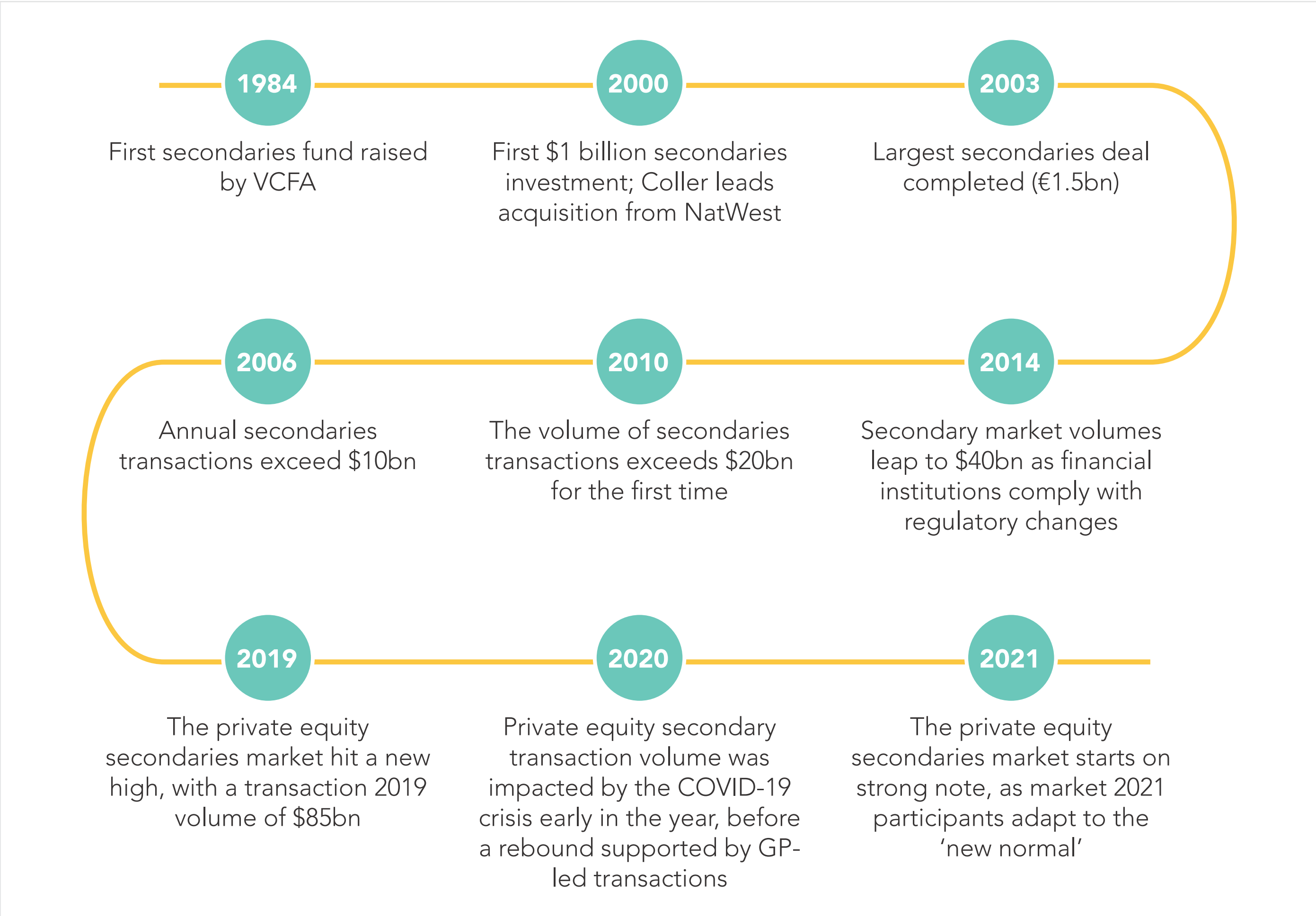


8. Appendix

8.1 History - Changing landscape of the PE market

In 1982, the Venture Capital Fund of America (VCFA) founded by Dayton Carr was the first investment firm to raise a secondaries fund. The objective of the fund was to acquire equity interests in the existing venture capital, leveraged buyout and mezzanine funds, as well as direct secondary interests in private companies. However, the first big push to the secondaries space came after the dot com crash when several investors wanted to liquidate their outstanding commitments in PE funds.

Exhibit 10: Timeline of events for PE secondaries



Source: SGA, Coller Capital

Initially, secondaries were a niche market characterized by limited number of buyers, stressed sellers, and deeply discounted prices. Due to frequent involvement of the larger players and an increase in participants, volume growth followed suit and discount on the pricing reduced. In the past two decades, the PE secondaries market emerged as an established investment platform across the world.

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