Navigating the secondary market for private equity

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Understand discounts, know your intermediary and more in secondary markets.

Welcome

Traditionally, private equity (PE) has been treated like a double-decker bus on a NASCAR track: an asset class that moves at its own pace, isn't readily maneuverable, and forces the rest of the portfolio to navigate around it (not vice versa). Increasingly, PE is becoming a more steerable asset class, thanks in large part to the speed at which secondary markets are evolving.

Over the past decade, the secondary market for PE has expanded sixfold to reach a total of $150 billion transacted in 2021.[1,2] The result for investors is the potential to more actively manage their PE holdings by having finer, more fluid control over risk exposure, cash flows, timing of when returns are realized and how well their PE holdings complement the rest of their portfolio.[3]

And even if investors aren't seeking to more actively manage their PE positions, the secondary market still offers novel benefits, especially when it comes to handling liquidity, running an evergreening program for PE and conducting whole-of-portfolio management.[4]

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[1] See: https://www.collercapital.com/about-secondaries/history-secondaries. There were at least 2,300 recorded secondary PE transactions in 2021, with an average deal size of around $60mm [Setter 2022].
[2] This compares to a $4.5 trillion market in assets under management for PE overall [McKinsey 2021].
[3] For example, if risk exposure elsewhere in the portfolio has changed, the PE portion of the portfolio might be partly 'rebalanced' to better handle that changed exposure.
[4] Regarding PE evergreening, secondary markets can help an investor achieve vintage diversification more quickly than would be feasible by buying into funds only at their launch dates.

NTK

Here is the 'need-to-know' from this Primer:

- **Increasingly multifunctional.** The secondary PE market has far more to offer than just liquidity for sellers and discounted assets for buyers.[5] Investors should examine their reasons for transacting or not, and consider deal structures that may serve multiple goals.
- **Savvy discounting.** Most secondary deals are priced at discounts to net asset value — and the size of these discounts is a big determinant of success in the secondary market, particularly for buyers.[6] It's a best practice to analyze what forces drive the discounts behind a given transaction, and assess whether they're fair and rationalizable.
- **Responsible intermediation.** About 80% of secondary deals are intermediated by specialists.[7] Knowing your intermediary — and ensuring their interests align with yours — is a best practice for any investor looking to reap the most value from a secondary transaction.

Significance

Any negative reputation the PE secondary market may have had is definitely not justified today. The secondary market has come to serve a crucial role in PE, and the opportunities for buying and selling assets are nearly as diverse as the assets themselves.

For sellers, there are many reasons why secondaries may be attractive:

- **Liquidity:** About half of secondary transactions involve stakes in PE funds. Rather than having capital tied up for a decade (or often longer), a secondary sale means LPs can exit at a time of their choosing.
- **Regulatory change/shareholder pressure:** A lot can happen over the lifetime of a private asset and owners of PE stakes may encounter unforeseen changes in

[5] Moreover, secondary markets have historically been a province for institutional investors only. But that's changing now, as the character of buyers and sellers becomes more inclusive (and creative!).
[6] Customarily, discounts are usually taken with respect to the assessed net asset value (NAV) of the asset for sale.
[7] The percentage of intermediated deals also seems to be increasing: it was estimated that 65% of deals in secondary markets involved intermediaries during FY 2020, vs. 80% in 2021 [Setter 2022].

the course of ownership, e.g., a sudden need to offload assets with weak ESG characteristics.

- **Rebalancing, refocusing or risk-shifting:** Over time, a specific asset may become a poor fit for a portfolio — even if the asset itself performs according to plan.

- **Locking in returns:** Investors may need to convert paper gains into, simply, realized gains.

- **Changed outlooks:** Sometimes it becomes clear that an asset won't hit expectations or that capital could be productively deployed elsewhere. It can be rational to sell out of a private, illiquid position at a discount and reallocate the proceeds to more effective ends.

- **Conflicts with leadership:** Occasionally, irreconcilable differences arise between investors and an external manager where the latter is the general partner of a PE fund or the manager of a private company in which the investor owns direct stakes.

For buyers, the opportunities for secondary market transactions are just as plentiful, including:

- **Shortened duration:** With suitable discounts, buyers can earn traditional PE returns but with abbreviated holding periods.

- **Decreased uncertainty:** Secondary buyers often enjoy greater certainty than they would in the primary market, e.g., buying into a fund at inception.[8] This may come from knowing the companies or assets a fund will purchase or having greater clarity on when capital is likely to be called.

- **Downside protection/return purity:** For many secondary buyers, a significant fraction of their return comes from discounted purchase prices. This lessens some of the risk they'd otherwise face if returns relied chiefly on cost of leverage or company growth, as is typically the case for primary PE stakes.

- **Diversification:** The secondary PE market can enable buyers to perform vintage diversification in far less time than would otherwise be possible. The same is

[8] One manifestation of this decreased uncertainty is mitigation of the 'J-curve' (e.g., shifting it forward in time or changing its steepness). See Pitchbook [2017].

true for diversification across GPs and fund strategies, e.g., achieving a mix of VC, LBO, infrastructure funds or similar.

- **Improved access:** Often, GPs grant their LPs a right-of-first-refusal to join subsequent funds. Buying an LP stake on the secondary market may allow investors access to future opportunities that otherwise wouldn't be available, e.g., if subsequent funds may be oversubscribed.

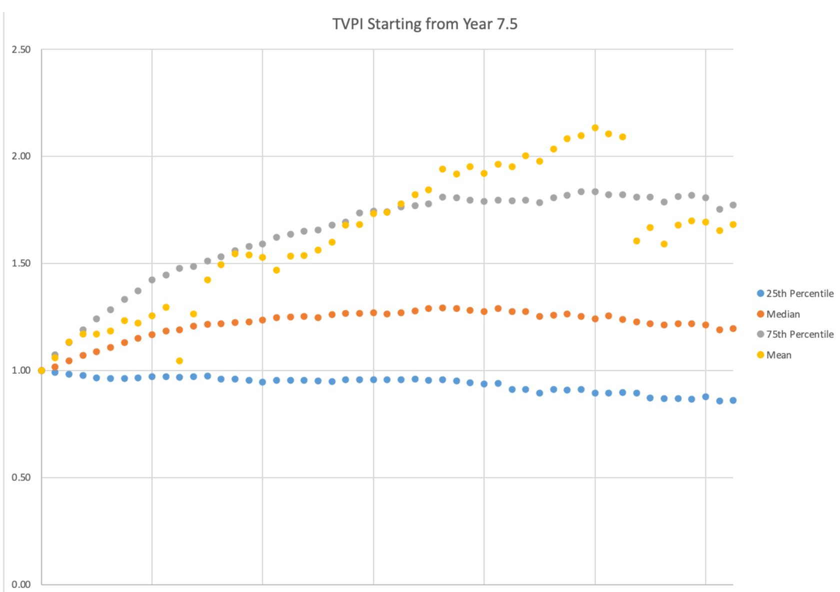
- **Customization:** Selective purchases allow investors to build bespoke PE portfolios that wouldn't have been available from any one GP on its own.

These opportunities and motives account for some of the rise in popularity for the PE secondary market. Other reasons, however, are less publicized. One of these can be shown from our own research (utilizing data available from Preqin), which is encapsulated in Figure 1 below.

This figure summarizes statistics on total value paid in (TVPI) values for over 5,600 PE funds over the past 30 years, beginning at year 7.5 of the fund's life. A TVPI greater than 1.0 indicates an increase in the value of an LP position; a TVPI less than 1.0 marks a decline in value. It's plain to see that many funds fail to deliver significant value in their final years — and more than 25% of funds actually *destroy* value!

Figure 1

Total value to paid in (TVPI) of PE funds in later life



Source: Addepar Research (based on Preqin data).

So, what are the mechanics of the secondary market for PE, and how do investors go about maximizing the value they can get from transacting in that market?

Context

Secondary PE transactions aren't all quick-and-simple. Instead, the usual transaction is more like selling/buying a home, a transaction that takes time, as it requires various inspections, appraisals, arrangement of financing and more.

In any transaction, there's clearly at least one buyer and one seller, although some transactions have more than one of each. A majority of deals feature multiple prospective bidders because that tends to help maximize value for the seller. Let's take a look at the characteristics of sellers and buyers, respectively.

Sellers can be classified by not only who they are, but what they're selling: LP stakes in PE funds or direct holdings in private companies.[9] For sales of fund stakes, positions in leveraged buyout funds are the most popular assets to sell (about 75% of sales in LP stakes in 2021 were for LBO funds), followed by LP positions in venture capital funds (about 15%) [Setter 2022]. The average age of a fund position sold on the secondary market was between 5 and 6 years[10] However, significant transaction volume exists at all stages of a fund's life, which points to the diverse reasons why sellers choose to exit their LP positions.

Sellers themselves are also diverse, although institutional sellers (for instance, pension funds or sovereign wealth funds) are most prevalent. About a third of all secondary deal volume is GP-led, meaning the general partners in a PE fund help coordinate the voluntary sale of fund assets, whether this is for single companies in the fund's portfolio or for an LP's entire stake in the fund [McKinsey 2021].[11]

[9] There's a roughly equal split in terms of the number of sales that are fund stakes and number that are directs [McKinsey 2021; Setter 2022].
[10] Setter Capital [2022].
[11] The number of GP-led secondaries for single assets is about the same as that for full LP positions [Triago 2021]. GP-led secondaries have become increasingly popular since the Global Financial Crisis of 2007–2009, before which they were relatively uncommon [McKinsey 2021].

As far as buyers go, there are many types, some of which include:

- **Latecomer LPs:** buyers who prefer less risk, seek diversification or for some reason couldn't join a fund at the time it closed.
- **Choosy FoFs:** funds-of-funds with dedicated allocations for secondary purchases, for the sake of risk management, bargain-seeking or both.
- **One-off opportunists:** hedge funds or other investors who are mainly concerned with very specific deals.
- **Dedicated secondary funds:** buyers (including many continuation funds by GPs) that are exclusively interested in secondary purchases.

In terms of buyer activity, specialized secondary funds account for most of the total deal value in PE secondaries (about 88% in 2021), with funds-of-funds (FoFs) accounting for a further 10% of activity [Triago 2021]. The amount of dry powder available for secondary purchases is rapidly growing, with an estimated $240 billion intended for secondaries in 2022 [Triago 2021], much of it controlled by FoFs. But this capital is concentrated and controlled by a small number of buyers.

Indeed, concentration of buyers is a characteristic of the PE secondary market in general: in 2021, the 25 largest buyers in the market accounted for >75% of overall deal volume [Setter 2022]. Yet, despite this concentration, smaller deals can and do flourish.

Viewing a secondary deal from an ecosystem perspective is vital for understanding who's likely to participate in a sales process and the amounts that competitive buyers might willingly pay. This is one of many reasons why most secondary PE transactions are intermediated. In using intermediaries, it's important for both buyers and sellers to be aware of:

- Whose interests (the buyer's or seller's) are being represented by which intermediaries — rarely, if ever, should a single intermediary represent both buyer and seller.
- What those various intermediaries are or aren't willing or able to do.

The most powerful intermediary is often the transaction manager that helps the seller find suitable buyers. In many situations, this transaction manager also helps: facilitate buyer diligence (e.g., by setting up a secure digital data room); communicate with GPs; and run auctions. Because transactions in this market are very heterogeneous, it's not uncommon for the same intermediaries to play different roles in different transactions. What's most crucial is that every investor ought to KYI: know your intermediary, in terms of what that intermediary's obligations, incentives and capabilities are for your particular transaction.

In addition to intermediaries, it's imperative to discuss discounts. Most deals in the PE secondary market are done as discounts to the net asset values (NAVs) involved in the transaction. Discounts are highly variable across time (e.g., quarter to quarter) and seemingly similar assets. There's no set formula for calculating it.[12] As a best practice, investors should consider the major factors individually and how they may combine into the final discount that's reflected in buyers' offers.

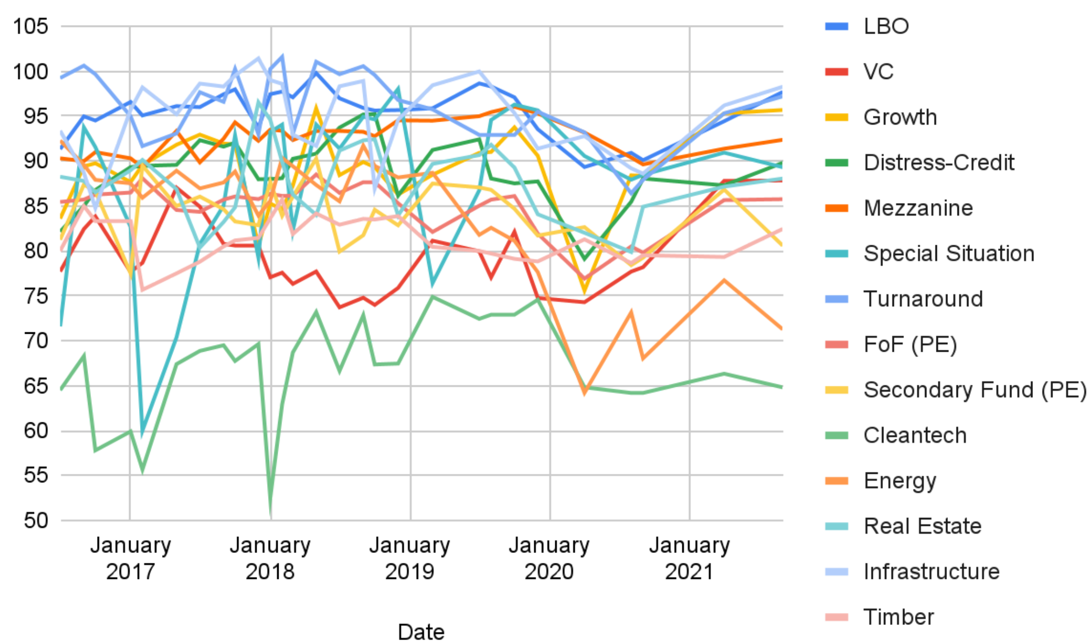
Figure 3 depicts average discounts from deals in the PE secondary market for fund-stakes of various types, as a percentage of NAV. At least two features jump out from this chart:

- There are wide gaps in average discount levels between different types of PE funds — from >40% down to slightly negative discounts, i.e., premia.
- The average discount levels themselves, even within a fund type, are heavily variable over time.

[12] Ideally, the discount gets optimally priced by a well-run auction. This is why it's so important to know your intermediary (KYI) and understand whether they're able to run an efficient and effective auction.

Figure 2

Prices of PE secondary transactions over time (fund-stakes as % of NAV)



Source: Setter Capital price reports, 2017-2021.

Factors driving this variability include: asset condition; degree of transparency, deal-specific factors including the degree of anonymity among deal participants and whether reasonable deal comps are available, marketwide conditions (e.g., how strong IPO market is), timing (e.g., how young or mature a fund is, tax year timing), a GP's stance on a sale, and whether one party is more incentivized to get the deal done efficiently — with high speed or low complexity, or both.

A good intermediary should help an investor navigate such factors. Indeed, the intermediary's competency may be the biggest factor of all in dictating the discount for a particular deal, which further underscores the need to know your intermediaries.

Conclusion

For investors considering getting involved in the PE secondary market, we've identified some best practices that investors should retain:

- **Experts:** Use PE secondary markets as a tool for the active management of private equity, but use it responsibly. Just like leverage and derivatives, using secondary transactions judiciously can be an efficient way to do things that ordinarily might not be feasible. But when used improperly, they can destroy hard-earned value. Feeling well-informed and comfortable with a transaction should be a primary concern for investors — as with exotic derivatives, you don't want any confusing deal mechanics or terms.

- **Trust:** Think of selling and buying in secondary markets as not unlike selling or buying a home — it's a transaction that can serve multiple ends including diversification, a toehold with a top-notch GP, liquidity/cash-flow management and more. It's invaluable to take the time to find the right intermediary, educate yourself and try not to see value (in specific, discounts) too narrowly.

- **Network:** Reach out to other investors to learn more, not just on deal mechanics, but also on their experiences with particular intermediaries, novel deal structures they've encountered and what discounts they're seeing. For all its evolution in recent years, visibility is far from perfect in the PE secondary market, and sharing experiences and information can be a great way to increase the odds of a successful transaction.

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