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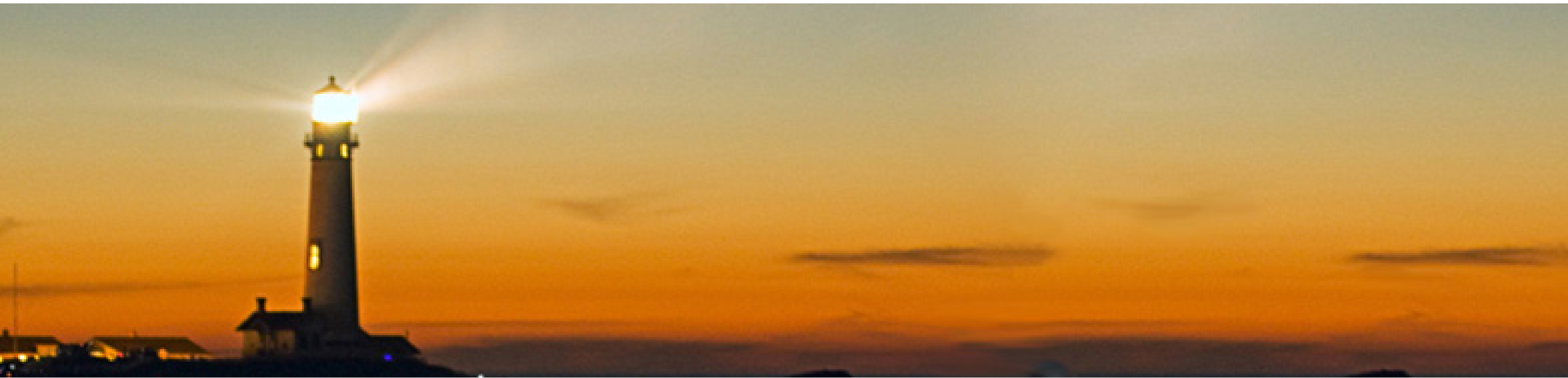

PA Insights: Private Market Secondaries

The liquidity challenges of private market investments offer compelling opportunities for secondary managers with strong platforms

While potentially offering lower correlations, less volatility and attractive risk-adjusted returns over time, the inherent lack of liquidity that comes with private equity or credit funds elicits a common refrain when speaking to investors in these asset classes: How do we manage liquidity on our timetable? While some advantages can accrue from this inherent illiquidity – including the ability to invest through bull and bear cycles and to be patient when it comes to capital allocations – the long lifespans of most private markets funds means limited partners ("LPs") are typically unable to exit ahead of schedule. This facet has always represented one of the largest challenges of the private markets asset class – and the funds that invest in it.

The secondary market addresses this challenge. In a straightforward secondary transaction, an LP in a private equity or credit fund is able to sell all or part of its interest to another investor, in a negotiated transaction between seller and buyer. The original LP may have any one of a number of reasons for wishing to exit early – among them perhaps wanting to raise capital, leave a particular manager, pro-actively rebalance allocations or shift investment strategy in another direction.

Key Takeaways

Private market transactions are inherently illiquid, often constraining an LP's flexibility.

The post-crisis environment has lead to more active management of portfolios, using secondaries to raise cash, exit a particular manager, re-balance exposures or shift strategy.

Advantages to a purchaser can include increased diversification, lower blind pool risk, mitigation of the J-curve, and attractive pricing.

Robust relationships with private equity LPs and fund sponsors are key to knowing what stakes are for sale and who is looking for replacement LPs.

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For buyers, secondary transactions can offer a number of compelling advantages over the primary, or direct, private equity fund approach. For instance:

- **Added diversification:** Secondaries can allow investors to improve portfolio diversification, spreading risk across multiple fund sponsors, vintage years, geographies, industries and investment strategies.

- **Lower blind pool risk:** Traditional private equity funds typically raise capital commitments from LPs prior to making any investments, so the portfolio, or pool, of new investments has not been assembled and LPs have no "visibility" into the portfolio (i.e., it is a "blind pool"). By contrast, in a secondary transaction, the investments underlying a given fund are often established and can be assessed by the buyer. This provides a golden opportunity to independently value and price the assets in question.

- **J-curve mitigation:** Since the underlying company investments in a secondary transaction have already been made by the fund manager whose interest is being acquired, private equity's infamous j-curve effect – which describes how a fund's performance is low or negative in the early years due to capital drawdowns and an unseasoned portfolio, and then climbs sharply as liquidity events unfold in the later years – is reduced because the secondary investor is entering the fund at a later stage in its life cycle. Investing in secondaries can also mean quicker capital deployment for buyers, shorter holding periods, and less waiting time before meaningful distributions occur.

- **Discounted pricing:** As with many assets in illiquid environments, because private equity fund interests are not marked to market on a tradeable public exchange, fund interests in secondary transactions may be priced at discounts to the fair market value of the portfolio components they represent. For astute buyers, this can translate to the ability to acquire valuable assets "on sale" and participate in funds managed by top-shelf managers who might be otherwise inaccessible.

Unsurprisingly, the low-return environment since the 2008 financial crisis has encouraged more active management of the private equity

Meet Our Senior Secondaries Team

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Managing Director

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portions in many investor portfolios, with investors keen to rebalance exposures as market conditions or strategies dictate. Meanwhile, interest in secondary opportunities to acquire earlier vintage year funds has risen in recent years on concerns that many of the more recent private equity funds may be paying heavily inflated prices for assets. The mix has led to a surge in secondary activity, with records set last year in number of funds closed, total capital raised, and dollar volume of secondary transactions.

Keys to Secondary Success

Because each transaction is a negotiated one, secondary strategies rely heavily on the network of relationships that can be brought to bear on this activity. The stronger the relationships with private equity LPs are, the more likely it may be that a secondary fund manager will be informed of potential stakes for sale. At the same time, the stronger the relationships with the general partner fund sponsors with whom they invest are, the more likely it may be that the secondary fund manager is approached by general partners looking for replacement LPs to step in when one of their existing investors is planning to sell its position.

Accordingly, investors considering placing capital in a dedicated secondaries strategy should measure the degree to which the manager is viewed as a strategic partner by both the universe of LPs in direct private equity funds and the general partner sponsors of such funds. Generally speaking, the more robust a secondary fund manager's network is, the better the opportunity set will be.

With some larger firms, this network effect can have cross-pollination advantages across different silos of investment. Portfolio Advisors has deep and broad relationships in four multi-dimensional spheres – private equity, co-investment, real estate and private credit. Such a comprehensive network can provide two additional advantages:

- First, it provides the secondary manager with asymmetrical access to information. For instance, Portfolio Advisors tracks, analyzes and reports on the performance of billions of dollars in private equity commitments across nearly 2,000 global private equity funds on behalf of its clients. The level of portfolio company detail and cash flow data that flows from this informational advantage is very useful when evaluating and pricing secondary transactions.

- Secondly, it provides the secondary manager with asymmetrical access to opportunities. Private equity general partners play a key role in the secondary process, since they must approve transfers of interest to new investors; long-standing relationships with key GPs and a reputation as a serious, committed buyer of secondary interests means the secondary manager may be presented with transactions that might not be broadcast to the broader marketplace.

From there, it's important that the secondary fund manager bring a degree of focus to bear on the wide breadth of opportunities that arise. This can be accomplished in a number of ways, including segment focus and having a dedicated secondaries team able to concentrate entirely on a specific niche. Such focus

may enhance a fund manager's ability to be selective, taking transactions that best fit the mold, which in turn helps avoid compromises on price or quality.

Conclusion

Private market secondaries are a fast-growing niche within the alternative investment landscape, and in recent years they have gone from relatively rare events (historically seen as a last resort by LPs) to an accepted and effective mechanism for institutional portfolio management. Indeed, investors now use the secondary market as a way to engage with established private equity funds.. As the size, scale and sophistication of the secondary market gains momentum, differentiators such as platform relationships, niche focus and informational advantages will play larger roles in determining a secondary fund manager's ability to see and select top-shelf private equity secondary opportunities with mature assets at attractive prices. ■

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