Private Equity Domain

*Mill Creek Capital Advisors' quarterly publication, **Private Equity Domain**, focuses each time on a specific aspect within one of the major sub-segments in private equity – Buyout Funds, Venture Capital, Debt/Credit Funds, Real Estate/Real Asset Fund, or Secondaries.*

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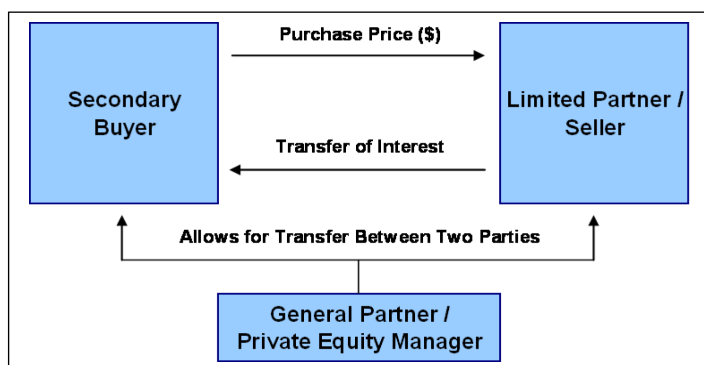
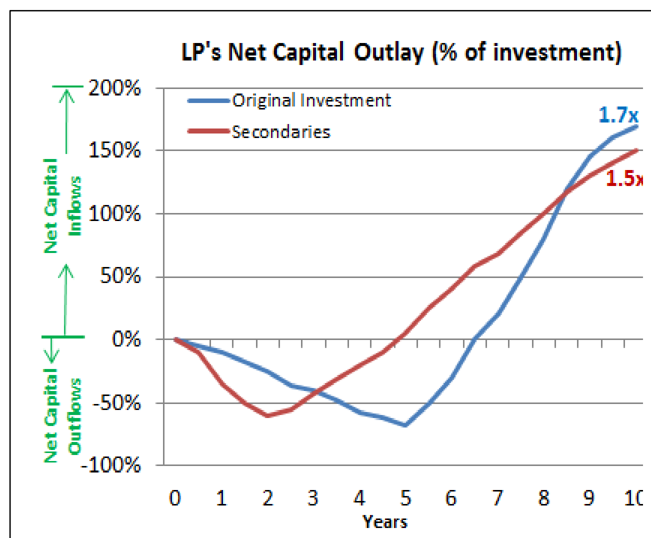
What are Secondaries? Although we find the term can be flexed a bit, in general, it refers to the buying and selling of pre-existing private equity interests from one Limited Partner (LP) to another LP, as shown in the diagram below. The holdings may be in a specific venture fund or the holdings could be a mix of interests from several of the private equity sub-segments. Given the private nature of the private equity funds and most of their underlying companies/assets, buying and selling in the secondaries market is complex, labor-intensive, and costly.



While the first secondaries fund (a fund of secondaries interests) was formed in 1982, the market did not gain much traction or acceptance until 2000 (Diagram on next page). The secondaries market place expanded rapidly in the early 2000s, as the volume of secondaries sold moved from 3% of the outstanding private equity base to 7% of the annual base outstanding. Secondaries then contracted abruptly with the Global Recession (transaction equaled only 1% of the base), but since then the volume has expanded back to the 6%+ mark. A review of secondaries transactions highlights that most of the reselling and buying is done to fine-tune existing private equity portfolios, with the seller looking to make space for new private equity investments and the buyer looking to add older private equity interests to diversify across time, industry sectors, geographies or all of the above. More details are given below on why buyers buy and sellers sell.

Why secondaries are attractive to buyers. There are many reasons. One reason is to access more mature companies and obtain a more rapid return of capital.

Most secondaries are purchased when investments are in the 4 to 7 year range, at which time some underlying companies/assets are being sold, and principal and gains are being returned to investors. By investing in the aged secondaries, investors can eliminate several years of net capital outflows that have no matching capital inflows yet. However, due to the transaction costs and a generally higher entry price, secondaries investors will hypothetically make 1.5x times their invested capital versus a hypothetical 1.7x return gained by the original investors (Diagram below).



A second reason is to access older vintage years, thereby adding time diversification ("vintage year" refers to the calendar year in which a private equity fund makes its first investment in an underlying company, security, or asset).

A third reason is to gain exposure to geographies and industry sectors that are lacking or under-weight in an investor's portfolio, thereby improving several aspects of diversification. Due to the wide variety of Secondaries Funds and intermediated options, investors can purchase interests in more specific industry sectors or geographies, as desired.

Fourth, on rare occasions, secondaries might be a cheaper alternative to investing in private equity, relative to buying interests in newly formed funds (which are called primaries or primary investments in private equity). Note that while secondaries are often quoted at "a discounted price", that is a discount to the current Net Asset Value (NAV), not a discount to the original investment value. Most funds experience an increase in NAV after the first year, as the underlying companies grow. So, in most cases, it is cheaper to purchase the private equity interests at inception rather than when companies are more mature.

Why LPs seek to sell existing interests. Although occasionally an LP might try to sell interests in an under-performing private equity fund, that is very rare today and was never very common.

When the secondaries market really got started in the early 2000s, selling interests to a secondaries buyer was very difficult, because the General Partners (GPs) managing the funds could and still can block such a sale. In those days, GPs did not a want a stigma or a suggestion that there was something wrong with their partnerships. Language contained in the Limited Partner Agreements (LPAs) and subscription documents gave and continues to give GPs the right to block any secondary sale.

That began to change when larger institutional private equity investors needed to reduce their holdings following mergers, of which bank mergers at that time were a prominent example. When two banks (each fully allocated to private equity) would merge, the newly combined entity was often a bit smaller after selling branches or business lines to meet regulatory demands. Thus, the consolidated portfolio would be momentarily overweight to private equity and seek to sell some private equity assets to bring the portfolio back to targeted allocations. However, that did not mean that the newly consolidated bank would not be eager to purchase new interests in future private equity funds, as the consolidated bank expanded and its older private equity interests matured. GPs wisely began to allow secondaries sales, particularly when the banks were selling a large number of private equity holdings, such that there was no stigma attached to any one underlying fund.

With the Global Recession in 2008-2009, a greater number and variety of institutional investors needed to downsize their private equity holdings, including endowments, foundations, pension plans, insurers, banks, and some family offices. The sellers sought to conserve cash and avoid having to meet near-term capital calls. In more drastic cases, the institutions sold private equity interests to raise money. For a brief period of time the secondaries market did offer good discounts to some secondaries buyers. However, in recent years, secondaries have rarely been that cheap. Given the growth, acceptance, and maturing of the secondaries market, most secondaries are sold near full value and sometimes even sold at a premium.

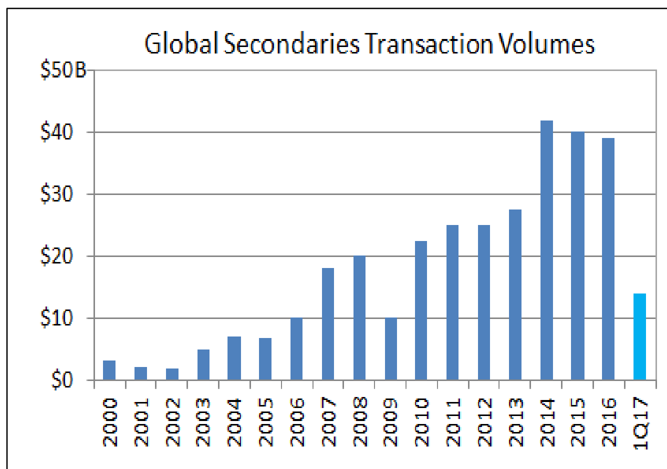
Most sellers are large institutions that are fine-tuning their portfolios and looking to sell older partnership interests to reduce the number of funds they must monitor and also make way for new private equity holdings. Occasionally, the selling may reflect management changes at an institution, where the new Chief Investment Officer wants to make a mark or undertake a different investment thesis. Note that selling comes at a cost (high transaction costs), so unless there is a highly compelling reason to sell, most investors do not resell their interests.

Many larger institutional investors seek private equity to provide handsome long-term returns, but they also view private equity firms and their underlying companies as potential customers – customers for loans, M&A fees, business consulting, insurance offerings, etc.

These large institutional investors are not purely interested in the price they can obtain when selling secondaries; rather the secondaries sales are part of a customer-procurement process, whereby the institution sells secondaries to make room for new investments and potential new customers for their goods and services.

Secondaries Funds and Intermediaries. Today there are secondaries funds of all sizes and shapes, as well as dozens of secondaries intermediary firms. The larger secondaries funds (funds that buy secondaries and create a new fund that is sold to LPs) tend to purchase older partnership interests being sold regularly by the large institutional investors that are making way for new funds. The mid and small-sized secondaries funds buy from smaller institutional sellers and family offices. Meanwhile, the growing number of intermediary firms are looking to match-up smaller buyers and sellers, while simultaneously taking a good sized fee – thus, supporting the idea of the secondaries market as a means to broaden diversification, and not as a way to buy private equity holdings more cheaply.

Conclusion. Secondaries play a useful role by: (1) providing liquidity to sellers (albeit at a hefty cost), and (2) providing a method for private equity investors to improve diversification in their existing portfolios.



Sources: Mill Creek, Real Deal, Preqin, Greenhill Cogent.

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