Key words: private equity; secondary markets; illiquidity

The evolving secondary market for private equity

As a result of the global financial crisis, interest in secondary market private equity has increased over the past 12 months. Following the sharp downturn in listed equity markets, many investors with targeted asset allocation levels found their policy threshold limits under threat. Other investors not necessarily following strict asset allocation targets were also under pressure to exit private equity (PE) investments due to deleveraging, and attempts to avoid future capital calls and minimise expected losses. The growing and evolving secondary market provides a channel for primary investors to exit illiquid investments such as PE.

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Investing in illiquid asset classes

In recent years, long-term illiquid asset classes have appealed to a range of investors including pension funds, university endowments, high net-worth individuals and banks. Indeed, the benefits of investing in less transparent and less efficient markets have been espoused by many investors, including pioneers such as David Swensen of the Yale Endowment Fund. During the buoyant years of 2003–07, an abundance of liquidity spurred a significant growth of interest in many new PE, mezzanine debt and venture capital funds. Current estimates of the size of global PE markets are well over US$1 trillion.

In the vast majority of cases, the risks of investing in long-term illiquid investments such as PE are clearly enunciated in the risk section of every PE information memorandum. The general partners (GP) or fund managers typically advise their limited partner investors (LPs) that key risks include:

- *An investment in illiquid assets*: PE investments are likely to be long-term and illiquid investments and not provide current and regular income.
- *Non-cash distributions*: Even at the end of a 10-year fund, some assets may not have been realised and the fund may be extended or assets may be distributed in kind.
- *Restrictions on transferability*: LP investors may not sell, transfer, exchange or assign their interests without consent of the GP.
- *Default by investors*: If an investor fails to contribute any part of its commitment, the investor can be subject to severe penalties including loss of capital previously contributed.

Such risks, which are often found buried in the back of an information memorandum, were dwarfed by positive publicity surrounding mega PE deals between 2003 and 2007. In addition, returns were strong and investors received regular fund distributions as assets were realised. However, many of the possible negative consequences of the risks associated with investing in illiquid assets have been realised recently through the global financial crisis (GFC).

The IPO market closed for PE exits, debt finance disappeared for real estate transactions and investors attempting to exit many hedge funds discovered they were gated. In addition, FAS157 in the United States provided new rules for revaluing PE investments, even if investments were intended to be held for the long term. Fund net asset values (NAVs)

were written down from June 2008 and this had an impact on leveraged investors. In addition, the drying up of fund distributions strained those investors who believed that they could rely on distributions to fund future capital calls. The secondary market was thus flooded with sellers. The most high-profile sell-down of PE assets was by the Harvard University endowment when it announced a US$1.5 billion re-weighting out of buyout funds in late 2008.

How to invest in secondary PE

The secondary market for PE was growing before the onset of the GFC and has provided investors with an opportunity to adjust portfolios for a wide range of reasons, the most common of which was a decision to reposition or rebalance a portfolio as part of more active investment management. Other common reasons for accessing the secondary market have been to remove loss-making funds, rationalise the number of funds in a portfolio and reduce the duration of an investment portfolio (as private equity funds run for 10 years or more). More complex secondary transactions arise from mergers between banks or insurance companies, which often result in an entire team of PE professionals and a portfolio of investments becoming surplus to requirements and being spun out through a secondary transaction. The secondary market not only provides flexibility for sellers, it can also provide solutions to buyers. For example, investors who were underweight in PE can increase their weighting through the secondary markets. Also, an investor who could not participate in the initial close of a fund can subsequently attempt to acquire a position through a secondary purchase. In a similar fashion, an investor can attempt to increase a position in a favoured fund through a secondary purchase.

There are distinct advantages to acquiring a PE interest in the secondary market. Besides potential price discounts, these include:

- *visibility into the portfolio being acquired* (buyers can assess the industry sector, gearing levels and geographical spread of the underlying fund investments);
- *minimisation of the J curve effect*, as most investments are in funds that have already been in existence for a period of time and have more than likely made a number of investments;
- *shorter duration investment profile*; and
- *potential fee benefits* if secondaries are acquired at a discount, as the GP carry threshold for the secondary purchaser is effectively more favourable than for primary investors.

There are two main avenues to acquiring secondary fund interests. The first is to *acquire assets directly from a primary investor* and the second is to *invest in a fund that is dedicated to secondary investments*. The first approach requires the secondary investor to conduct its own due diligence, negotiate with the seller, obtain approvals from the GP and complete settlement with an appropriate legal document. The latter approach assigns these tasks to a secondary investment specialist.

The GFC added substantially more pressure for PE exits, and this appears to be evident in the number and size of reported PE interests for sale, as the relative increase in secondary deal flow in 2008 clearly outpaced the growth of PE primary fund raising.

There are advantages and disadvantages in each approach. The first strategy is sensible if the investor has targeted a specific fund available for purchase or is familiar with a fund being offered for sale and has the skills and resources to complete the direct purchase. The second strategy provides greater diversification as a secondary fund may acquire many fund interests with dozens of underlying company investments. The specialist secondary fund manager will also hopefully have a greater deal flow and insight into the secondary market with initial pricing and eventual return benefits.

Growth in the secondary market

While formal aggregated statistics on secondary market activity are limited, a number of key participants in the market have reported a substantial lift in activity across 2007, 2008 and into 2009. One of the largest global investors in the secondary PE market reported an increase of almost 100% in deal flow in 2007 and an increase of close to 120% again in 2008. In effect, deal flow has increased over 400% since 2006. Regardless of the GFC, one would expect deal flow to increase as the volume of PE fundraising has increased substantially over recent years. The GFC added substantially more pressure for PE exits, and this appears to be evident in the number and size of reported PE interests for sale, as the relative increase in secondary deal flow in 2008 clearly outpaced the growth of PE primary fund raising.

Over recent years many new secondary funds have been raised. The level of commitments to secondary funds increased substantially between 2005 and 2007. According to Preqin's Performance Analyst database, the aggregate capital raised in 2007 reached a record US$13 billion across a total of 10 dedicated secondary funds. In 2008, while 13 funds were closed during the year, only US$6.9 billion was raised in total. This is perhaps understandable as the GFC made fundraising a difficult task. A number of funds were raising capital in late 2008 and early 2009 (see Table 1).

As at May 2009, three dedicated secondary funds had closed to date this year, raising a total of US$8.7 billion, which already exceeds fundraising for the whole of 2008. The appetite for secondaries should be strong, though the extent of fundraising depends on overall investment market sentiment and whether investors are prepared to commit to new funds before there is some confidence that the GFC has passed.

Secondary market pricing

Currently, there is no disclosed pricing index measuring and recording all secondary market transactions. Anecdotally, however, there has been a trend towards lower pricing, from approximately 15% discounts to NAV in early 2008 to around 40% discounts in late 2008 and close to 60% discounts by the first quarter of 2009 (see Table 2). These are broad-based 'average' discounts obtained from Cogent Partners (see source, Table 2). A key factor when assessing discount percentages is to determine the valuation against which the discount is applied. There is inevitably a lag factor involved as fund valuations are issued several months after the end of the period. Secondary purchases in 2009 are therefore not only being acquired at larger discounts, but also at discounts that are being applied to fund NAVs that are also now being written down. In the United States, FAS 157 requires general partners to follow a more structured approach to revaluing PE investments. In a weak market, this may result in less discretion to hold previous valuation levels.

Clearly, the prices referred to are general levels and the attractiveness of a secondary investment depends on a range of factors, including an assessment of the GP, underlying fund assets, capital commitments remaining and the fund vintage year. According to Preqin (see source, Figure 1), some limited partnerships have been trading at discounts of up to 90% on December 2008 valuations. Among the worst hit are 2006 and 2007 vintage year mega buyout funds. Some of these fund interests are actually trading at a negative premium whereby the seller, desperate to avoid defaulting on capital calls, effectively pays the buyer to take the fund interests off their hands. A degree of caution should be applied when assessing prices as the market for secondaries is evolving and specific transaction pricing could substantially be influenced by the level of stress of the seller.

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Interestingly, according to Preqin, the discounts at which venture and fund of funds were traded in April 2009 were actually smaller than in March 2009, the first time discounts had shrunk since late 2007. Buyouts saw a similar decline in the discount at which they were traded from February 2009 to March 2009. This improvement in pricing is also evident in Kohlberg Kravis Roberts' (KKR) and Blackstone's listed PE vehicles on European and New York stock exchanges by late April 2009. It is too early to determine whether the first quarter of 2009 marked the low point in secondary PE pricing. The new funds raised during late 2008 and the first quarter of 2009 will, however, be in an ideal position to take advantage of current discounted pricing.

TABLE 1: Funds raising capital in late 2008/early 2009

Fund	Manager	Size million	Focus
Goldman Sachs Vintage V	Goldman Sachs	US$5,000	US
Lexington Capital Partners VII	Lexington Partners	US$5,000	US
Pantheon Global Secondary Fund IV	Pantheon Ventures	US$3,750	Europe
Partners Group Secondary 2008	Partners Group	€2,000	Europe
CS Strategic Partners IV	CS strategic partners	US$2,500	US
Dover Street VII	Harbourvest	US$2,000	US
Pomona Capital VII	Pomona Capital	US$1,000	US
AXA Early Secondary Fund	AXA Private Equity	€600	Europe
Lexington Middle Market Investors II	Lexington Partners	US$750	US

TABLE 2: Discounts to net asset value

Time period	Discount to NAV	NAV Pricing
Early 2008	15%	Based on Q3 and Q4 2007 NAV
Late 2008	40%	Based on Q1 and Q2 2008 NAV
Q1 2009	60%	Based on Q3 and Q4 2008 NAV

Source: Cogent Partners.

Returns

Returns from secondary private equity investment have been strong for over a decade, including periods of both strong and anaemic markets. Figure 1, based on data from Preqin, confirms positive returns for over a decade. The close clustering of returns in the late 1990s and early 2000s is due to the small number of funds in the performance survey. As the number of funds has increased, a more typical dispersion of results has arisen.

The future

Secondary private equity funds have now been entrenched as a relevant adjunct to PE investment. It is important to note that the size of the secondaries market is likely to remain a small portion of the primary market, and that secondary funds are clearly not a substitute for primary funds. However, primary investors may feel less concerned about illiquidity and more comfortable investing in long-term PE funds as the secondaries market matures and expands over time. The returns from secondary funds have been excellent to date, albeit after only a relatively short history. The outlook for returns over the next few years continues to be positive and 2009 may well prove to be one of the most opportune times for secondary PE investors to capitalise on stressed primary investors. Even after the GFC has subsided, there will still be opportunities for secondary investors as primary investors decide to exit their positions due to portfolio repositioning and other factors.

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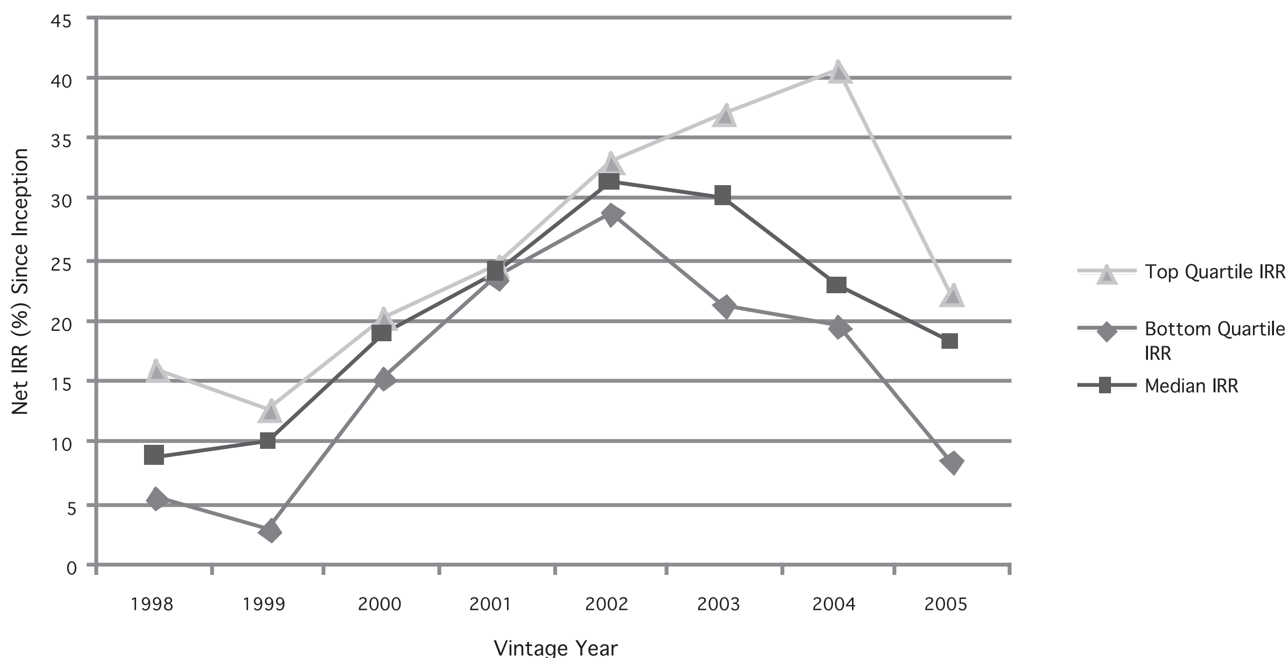
FIGURE 1: **Private equity secondaries returns**



Source: Preqin Private Equity Secondaries Review — March 2009.