



A Primer for Today's Secondary Private Equity Market

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The Evolution of the Secondary Market

Like any market, the secondary private equity market connects buyers and sellers, allowing the former to access private equity limited partnership positions beyond the initial investment period, and the latter to access liquidity along an earlier timeframe. As today's investors navigate a richly valued, low yield environment against a backdrop of global macro uncertainty, and as the role of the secondary market becomes increasingly accepted within the alternative assets universe, secondary investing is being considered in new ways – not only as a source of liquidity for distressed investors, but as a differentiated investment strategy and as a regular portfolio management tool to rebalance fund exposures and lock in realized gains.

The secondary market began to emerge as early

as the 1980s. Activity remained muted until the mid-2000s, when a confluence of factors began to drive increasing volume. Since then, secondary private equity has matured from a derivative asset class largely driven by distress and short term market volatility, to a broader, institutionalized market where seller and buyer types now include every investor category. Today, more secondary funds are in market and more capital is being sought than at any point in recent history.¹

Secondary market activity is influenced by public market dynamics, corresponding investor sentiment and the availability of primary private equity interests to market. Primary private equity fundraising tends to increase with strengthening public market conditions (Exhibit 1, next page). With each inflection point in financial markets over the past decade, the secondary market has also experienced increased activity as investors

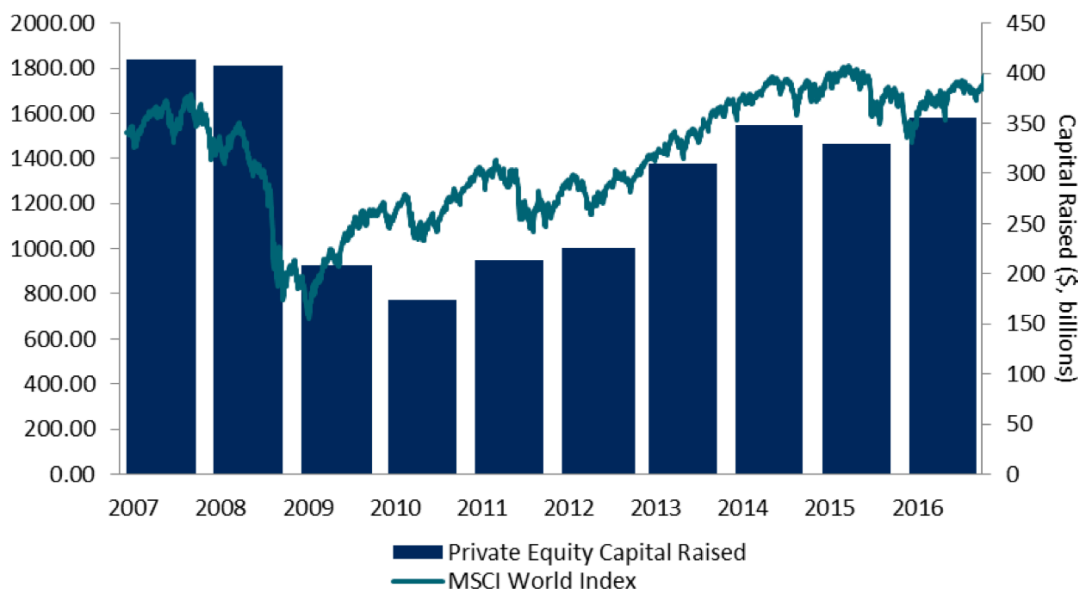


Exhibit 1: Primary Commitments and Market Performance (US\$ in billions) *

attempt to unload distressed stakes or to take advantage of market gains. (Increased activity does not always lead to completed deal volume, as will be discussed below.) The secondary market has experienced marked secular growth over this period as well, as buyers and sellers become increasingly sophisticated and as the volume and availability of primary private equity product has expanded over time (Exhibit 2, next page).

A Brief History

Pre-2000

Following regulatory changes in the late 1970s that permitted pension funds to invest in private equity, assets under management in the organized private equity market increased dramatically, from under \$5 billion to over \$175 billion between 1980 and 1995.² By the 1990s, private equity had become a core holding for most institutional investors, with average portfolio allocations ranging from 5% for public pension plans to nearly 15% for endowments and foundations.³ Secondary activity had existed from the early days, largely as one-off transactions. However, as the primary market matured through the 1990s, secondary activity began to grow meaningfully. The first globally focused secondary private equity fund was launched in 1998.

2000-2003

In the 1990s, regulators changed the capital requirements for commercial banks and insurance companies, forcing these institutions to set aside more capital in order to support their alternative asset investments.⁴ In 2000, Chase Capital Partners sold a \$500+ million portfolio of private equity fund interests to two secondary players, marking the beginning of larger scale portfolio transactions in the secondary marketplace as well as the beginning of buyer mosaics. In 2003, UBS sold a portfolio of more than fifty LBO and venture capital fund interests, estimated to be valued around \$750 million. That same year, Deutsche Bank also completed a fund portfolio sale. Following the global technology losses of 2000, sellers turned to the secondary market out of

distress as well. The market was marked by large discounts at this time, though the pricing gap between buyers and sellers began to narrow over the coming years as the exit climate for primary private equity assets improved, and as sellers had time to absorb several quarters of gradual balance sheet write-downs.

2004-2008

The secondary market landscape began to change in the mid-2000s as public pension plans began to sell assets from their private equity portfolios. In 2004, the State of Connecticut Retirement Plans and Trust Funds became one of the first pension funds to sell in the secondary marketplace. Secondary market deal volume was roughly \$8.4 billion for the year.⁵ Over the next two years, secondary fundraising surged, with Collier Capital raising a \$4.5 billion fund in 2007. In 2005, California Public Employee's Retirement System (CalPERS) decided to restructure its Alternative Investment Management program, creating a 'legacy portfolio' of non-core assets and manager relationships. In 2007, CalPERS sold this legacy portfolio to a buyer syndicate for \$1.5 billion, the largest secondary transaction to date. By 2008, secondary deal volume had almost doubled from 2004 levels, to \$16.4 billion.⁶

2009-2013

Following the global financial crisis, widespread market dislocations had a dramatic impact on the pricing of secondary private equity transactions, resulting in wide bid / ask spreads and muted volume. An expected surge in deal flow following the economic downturn failed to materialize, as investors resisted selling in late 2008 to early 2009 to avoid significant losses. However, through 2009 and 2010, the bid / ask spread narrowed and completed transaction volume increased significantly, as investors wanted to rebalance investment allocations and to reduce unfunded private equity exposure. In 2010, Bank of America sold a \$1.9 billion portfolio to AXA Private Equity, marking the beginning of truly large portfolio transactions. In 2011 and 2012, financial institutions again became increasingly

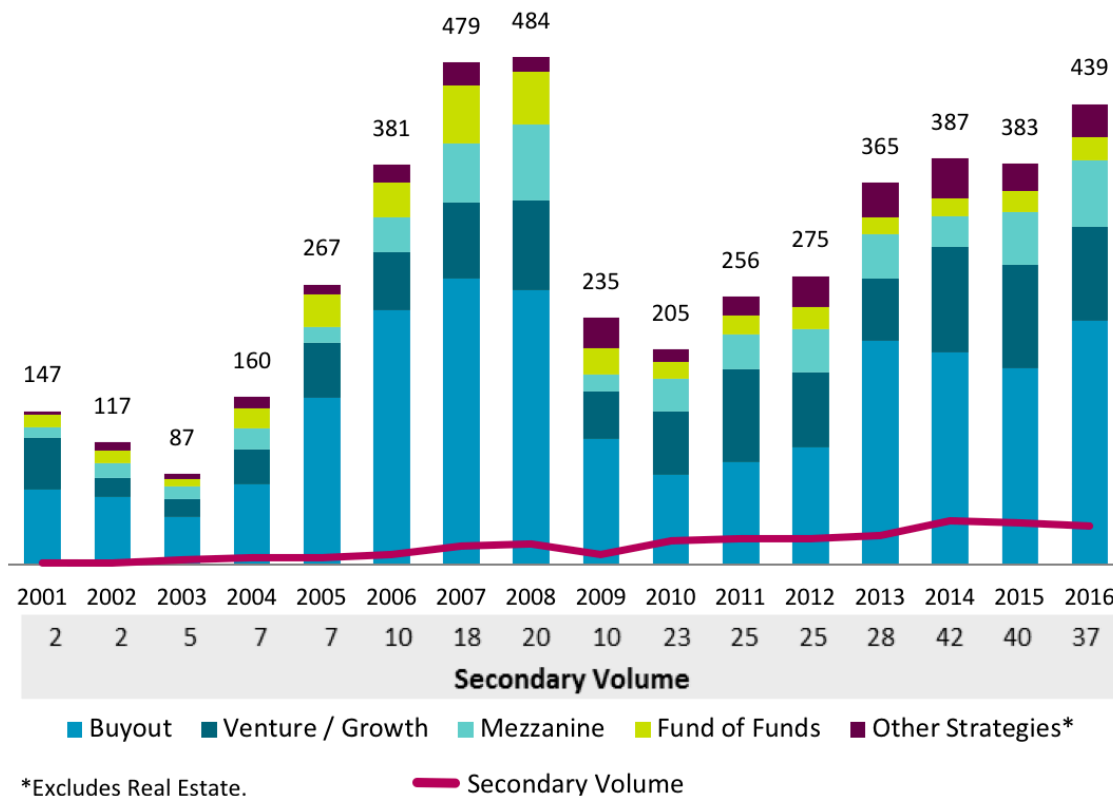


Exhibit 2: Primary Commitments and Secondary Volume (US\$ in billions)*

active sellers, driven by regulatory reform following the crisis, capped off by the release of the final draft of the Volcker Rule in 2013.

2014-Today

2014 and 2015 saw a meaningful jump in global secondary transaction volume, as public equity gains and strong realization activity through 2012 to 2014 flowed through to the secondary market. Exits from buyouts exceeded \$450 billion in 2014, surpassing the 2007 all-time high of \$354 billion.⁷ Continued strong secondary fundraising increased the amount of dry powder available, and new secondary market entrants emerged, including non-traditional buyers. Competition for high quality asset portfolios intensified and secondary market pricing grew robust, to a post-crisis high of 93% of Net Asset Value (“NAV”).⁸ More multi-strategy portfolios came to market, often including real estate and infrastructure / energy fund stakes. Deal volume hit record levels in 2014, driven partly by a dozen billion-dollar-plus transactions, including portfolios from GE Capital, Mizuho Financial and J.P. Morgan Chase, in addition to several large US public pension plans. Deals became increasingly structured, with buyers using deferred payment structures and third-party leverage to boost returns.

2016 posed yet another inflection point. In the first half of 2016, macro volatility driven by a drop in crude prices in January, worries over a China slowdown and Brexit slowed market volume. Although a large number and variety of potential sellers entered the secondary private equity marketplace seeking liquidity, many early 2016 deals were not completed as buyers and sellers had differing expectations, leading to yet another pricing gap. Pricing

for buyout fund stakes fell – the first half-yearly drop since 2013.⁹ Meanwhile, dry powder increased to a record \$65 billion, the joint result of slower capital deployment in the first half of the year due to market uncertainty and the successful completion of several large secondary fundraises over the year.¹⁰ As 2016 progressed, valuations in underlying portfolios began to stabilize and consequently, secondary buyers became increasingly willing to transact. As a result, the second half of 2016 saw a spike in completed transactions. 2016 secondary completed deal volume reached \$37 billion, slightly down from prior year volume of \$40 billion.¹¹

Where is the Market Going?

We believe the near term will be marked by continued volatility, driven by political uncertainty and a challenging market environment. In December 2016, the Federal Reserve extended the deadline for banks to qualify for the Volcker Rule extension, up to an additional five years beyond July 21, 2017 to divest legacy “illiquid fund” investments. Financial institutions, historically motivated by regulatory reasons to pare down their private equity asset portfolios, are now taking a “wait and see” attitude, especially in light of indications from the current U.S. presidential administration that further changes may be made to Dodd-Frank legislation.

While this will certainly impact the secondary market in the shorter term, we believe secondary activity will nevertheless continue to expand in size and scope over the longer term, both in the number of transactions and in total dollars transacted. While 2016 completed deal volume decreased almost 10% from

the prior year, this was largely driven by a decrease in average deal size (which fell from over \$200 million in 2015 to under \$180 million in 2016). Not only were more total transactions completed by number, but the average number of funds per transaction increased over 30% from 13 in 2015 to 18 in 2016.¹² As increasingly diverse portfolios are brought to market, and as more buyer and seller types recognize the secondary market as a viable portfolio solution, we believe secondary private equity will be poised for continued growth.

Going forward, we can identify several meaningful growth trends, including:

- A growing universe of players
 - Sellers driven by changing needs, macro forces and normalizing attitudes
 - Buyers driven by the search for yield and ample dry powder
- A broadening of assets available for sale
 - Widening spectrum in terms of quality, asset class and maturity
 - Growing asset backlog in the primary PE market
- The expanding role of fund of funds managers and general partners

A Growing Universe of Players

Between January 2015 and today, over \$70 billion of dedicated secondary capital was raised, an influx of dry powder waiting to be deployed in the next two to four years.¹³ As more capital enters the secondary market, news headlines increasingly reflect investor concerns over intensifying competition, “full” pricing and a supply / demand imbalance in the secondary market. A growing universe of players can mean more competition as traditional secondary players and institutional investors alike focus their attention on the same portfolios, often with larger-than-ever pools of capital. However, digging a little deeper, more market participation can also mean greater specialization and sophistication.

Over the past five years, the secondary private equity market has expanded meaningfully, from \$25 billion (2011) to \$37 billion (2016) in annual transactions.¹⁴ In the first half of 2016, pension funds became the most active sellers of stakes on the secondary market, overtaking financial institutions.¹⁵ Sophisticated institutional investors including pension plans and sovereign wealth funds are increasingly turning to the secondary market as a regular portfolio rebalancing tool. These same investors are also treating secondary private equity as an alternative investment strategy, committing to secondary managers in their investment allocations and even building dedicated, in-house secondary investing platforms. These platforms often have global reach and robust teams, reflecting a growing shift away from traditionally passive investing to more active market participation.

Approximately half of active buyers in the secondary market today are also sellers, and over half of all secondary buyers have the ability to purchase interests across multiple private equity strategies, suggesting that while competition in the secondary

market is certainly growing, participant sophistication is growing as well.¹⁶

A closer look at pricing levels in 2015 and 2016 reveals that par and premium prices were paid mostly on large-cap US and European funds, with well-diversified underlying investments and regular distribution streams.^{17,18} While “full” pricing is grabbing investor attention, these headline prices do not reflect the bifurcation of the market as buyers concentrate on assets perceived as higher quality. This pricing disparity becomes evident as one examines the average price paid for venture capital assets, with less predictable cash flow streams and less perceived upside potential, which was 78% of NAV, compared to buyout pricing, which averaged 95% of NAV in the same year.¹⁹

Buyers have also focused on broader subsets and large portfolios, where bidding was more aggressive, rather than niche subsets (where fewer buyers have prior knowledge, or access to information) or smaller portfolios (where fewer buyers are incentivized to transact, given the pressure to keep pace with capital deployment, and where opportunities may be off-market and more relationship-based). We believe this dispersion allows those buyers with more transaction experience or greater specialization to continue to find value in the secondary market. As a final point, secondary sale processes are generally based off a historical reference date, and underlying portfolio valuation changes over time can often be reflected in pricing, especially if buyers have access to subsequent quarters of information. Over periods of strong public market activity or meaningful private valuation uplifts, par or premium pricing for reference date NAV from three or six months prior may actually equate to a discount to latest market value.

The current secondary penetration rate (defined as the percentage of total NAV across all private equity strategies that trades in the secondary market) is still less than 2%.²⁰ Primary private equity makes up a growing proportion of investor portfolios, and investor demand continues to support robust primary private equity fundraising, driven by historically strong cash distributions over the past six years.²¹ As the primary market continues to expand, we believe the secondary market will follow suit (Exhibit 3, next page).

A Broadening of Assets Available for Sale

The expansion of the secondary private equity market has led to a broadening of assets available for sale. Sellers are increasingly coming to market with multi-asset portfolios, which reflect the realities of alternatives investing. Real estate, natural resources and infrastructure funds, asset classes which were not institutionalized until the mid-2000s, are being offered for sale both due to their maturation over time, and in response to growing investor appetite for asset diversification. The flight to quality discussed above has fuelled another growth trend in the secondary market, as opportunistic sellers are incentivized to “sweeten the pot” by blending in younger assets with greater perceived upside potential into portfolios available for sale.

Although down in 2016, active fund of funds portfolio management drove two-thirds of 2015 volume compared to just under half in 2014, a trend that will likely continue as transacting in the secondary market becomes increasingly normalized.²² Fund of funds managers are not only paring down mature

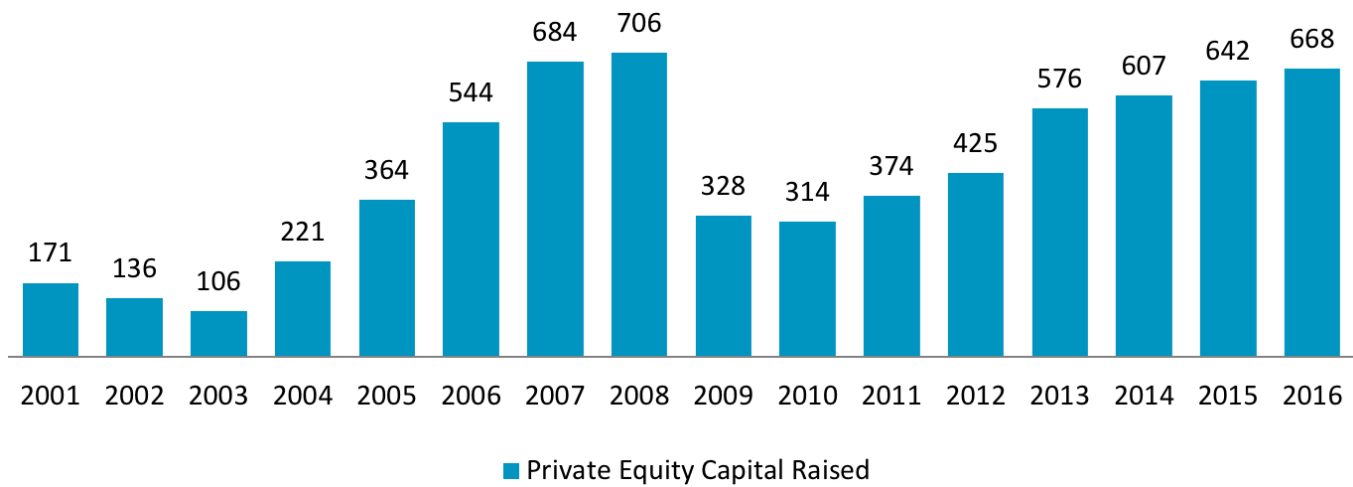
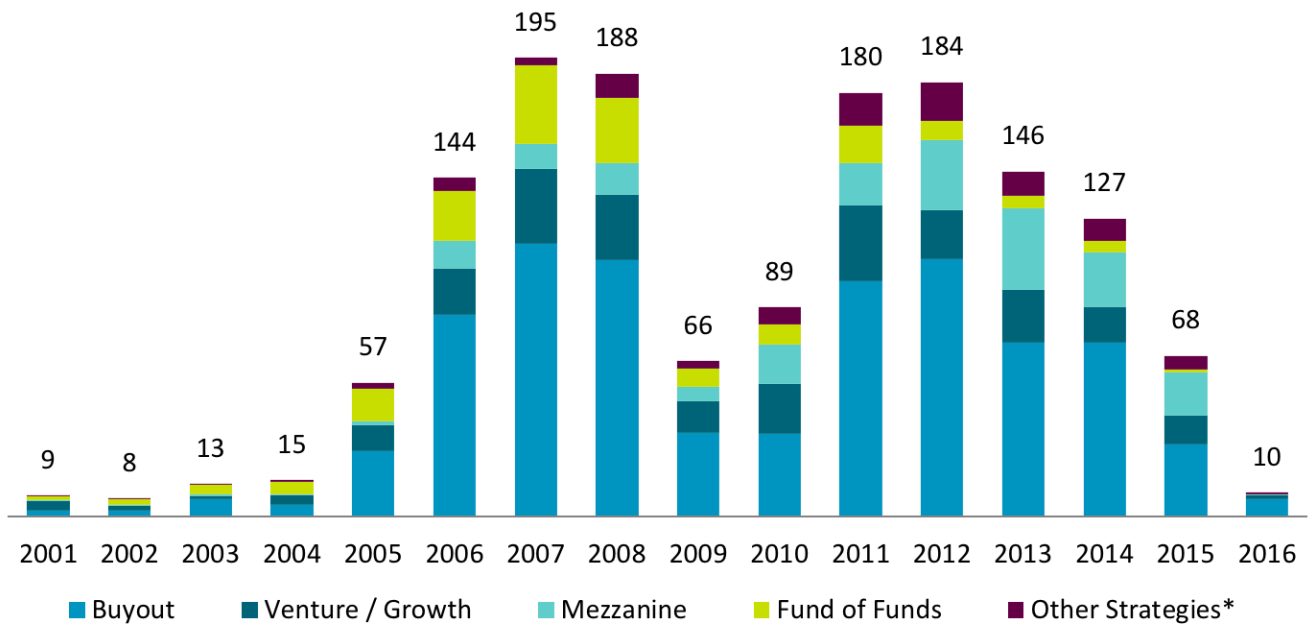


Exhibit 3: Historical Private Equity Fundraising (US\$ in billions)*



*Excludes Real Estate.

Exhibit 4: Remaining Value in Private Equity Funds by Vintage (US\$ in billions)*

assets in vehicle wind-downs, but also strategically selling younger assets. Fund managers may choose to sell down partial commitments, tailoring their exposure to certain private equity sponsors or investment strategies, but maintaining a foot in the door to capitalize on future upside, or to maintain the sponsor relationship.

As funds raised prior to the 2008 financial crisis hit the ten-year mark (the traditional “end of fund” life) and funds raised following the crisis gradually reach maturity, the maturity spectrum of the secondary market is not only expanding but also shifting generally. There is \$649 billion of remaining value in 2005-2009 vintages, which comprises the new “tail-end” opportunity set to enter the market over the next three to five years (Exhibit 4).²³

Younger, post-crisis funds will begin to shape the profile of secondary market supply. Primary private equity funds raised between 2009 and 2012 entered a depressed market, with three year rolling IRR horizons of 0.3% across all strategies.²⁴ With fewer opportunities to deploy capital early in their investment periods, these funds are not only younger, with more blind pool risk, but also distinguished by comparably longer active fund lives.

As PE funds raised over the past decade harvest the unrealized value in their portfolios, the average holding period has lengthened—and will continue to stretch because holdings acquired during the boom years have yet to be fully exited. Many pre-crisis investments were often acquired at high purchase multiples, and need more time in order to yield acceptable

returns. Likewise, holdings acquired following the crisis need more time for their investment theses to be proven out. For buyouts exited in 2014, the median holding period had grown to 5.7 years, up from just 3.4 in 2008. 60% of assets sold in 2014 had been in PE portfolios for more than five years; in comparison, only 11% had been held less than three years.²⁵

The Expanding Role of General Partners

Although the secondary private equity market emerged as a solution designed for limited partners seeking liquidity, general partners are becoming increasingly active participants. By virtue of the transaction between an existing limited partner and an aspiring buyer, the general partner (“GP”) is party to the exchange, though traditionally in a more passive role. However, GPs are initiating transactions directly on the secondary market, both independently, and on behalf of their limited partners. Greenhill Cogent estimates that GP-led transactions were 18% of 2016 total deal count, and just under 25% of the total secondary market, topping \$9 billion.²⁶

In recent years, we have seen GPs proactively offering investors liquidity options, as well as adopting new fund-level equity and debt structures to manage capital needs. GPs are also introducing greater complexity to the secondary market through restructuring / recapitalization processes, team spin-outs and secondary direct investments. These solutions are poised for additional growth, especially with the growing specialization of the market, as a broadening of asset classes introduces varying risk-return profiles, differing fund structures (closed-end, open-end, etc.) and investment time frames. In real estate, for example, select sponsors are shifting away from traditional closed-end fund vehicles towards deal by deal transactions and co-investments, as investor appetite is growing for smaller club deals.

General partners and fund of fund managers are running secondary processes often with an eye towards the primary capabilities of interested buyers, as a secondary transaction could present the opportunity for managers to enhance and structure their limited partner base. The secondary market becomes not only a tool for managers to “clean up” older, legacy investments, but provides access to a different, often new capital pool. Staple transactions, in which managers will allow prospective buyers access to existing funds only with commitments to new funds, allow fund of funds managers to balance limited partner commitments across vintages (allowing a limited partner to be released from an older vintage for the guarantee that the substituting party will commit to the latest fund raised, often at a pre-determined ratio of NAV).

Conclusion

As the secondary private equity market has evolved, the participant universe, asset spectrum and amount of available dry powder have all expanded meaningfully. We predict that the market will continue to grow more complex, mirroring developments in the primary private equity market, which can be traced along a similar trajectory from its early history to today. Just as private equity expanded across strategies (venture capital, real estate, infrastructure, etc.) and spread across the capital structure (mezzanine debt, distressed for control, rescue financing, etc.), we believe the secondary market will expand similarly.

Forward projections of traditional asset class performance remain underwhelming, and investors of all types are increasingly seeking out creative approaches to deploying capital and generating solid risk-adjusted returns in a challenging market environment. As investors turn to the secondary market as both buyers and sellers, increasingly broad asset portfolios will be brought to market, and increasingly complex solutions will emerge. For investors, it is important to keep sight of fundamentals in the face of increasing complexity. We believe intrinsic analysis of underlying assets can determine the “right price” for any portfolio, within any structure. With thoughtful portfolio construction, we believe the secondary market offers diversified exposure to the primary private equity market, indexed across vintage years, geographies, asset classes and strategies.

Though impacted by macro-economic trends and public equity volatility in broadly the same way as other alternative assets, secondary private equity is a derivative of the broader alternative assets universe, with a time lag and performance curve following that of the primary market. By removing some of the start-up risks facing private equity funds, secondary private equity investing may ultimately provide more efficient exposure to the alternative assets market, offering accelerated returns with lower volatility, lower loss rates and greater downside protection, regardless of the current market cycle.

** Source for all Exhibits: Preqin.*

Endnotes

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Authors' Bios



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Verdun S. Perry is a Senior Managing Director and Co-Head of Strategic Partners, Blackstone's secondary fund of funds business, which it acquired from Credit Suisse in August 2013. Mr. Perry joined Credit Suisse in November 2000 when it acquired Donaldson, Lufkin & Jenrette ("DLJ"), where he was an Associate in the Investment Banking Division before joining Strategic Partners the year it was founded. Mr. Perry sits on Strategic Partners' Investment Committees and his current responsibilities include fundraising, deal-sourcing, negotiating and executing secondary transactions and co-investments, as well as various post-purchase fund monitoring activities. Previously, Mr. Perry worked in the strategic investments group at Bozell, Jacobs, Kenyon and Eckhardt, Inc. and in the Investment Banking Division at Morgan Stanley & Co. Mr. Perry received a B.A. from Morehouse College, where he graduated magna cum laude and was elected Phi Beta Kappa, as well as an M.B.A. from Harvard Business School, where he was a Robert Toigo Foundation Fellow. Mr. Perry serves on the boards of The Blackstone Charitable Foundation and Sponsors for Educational Opportunity (SEO).



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Julie Chang is an Associate, having joined Strategic Partners in 2013. In 2016, Ms. Chang relocated to Strategic Partners' London office to complete a two year rotation. Prior to joining Strategic Partners, Ms. Chang worked for the American Chamber of Commerce in Almaty, Kazakhstan. Ms. Chang attended Princeton University where she was elected to Phi Beta Kappa and earned a B.A. summa cum laude in Classics, with certificates in European Cultural Studies, Medieval Studies and Russian and Eurasian Studies.