

A Brief History of the Private Equity Secondary Market

By Wm. Blake Winchell

The Private Equity Secondary Market (PESM) has characteristics that can benefit all players – limited partners, general partners, sellers, buyers and portfolio companies if an acceptable market clearing price can be reached. That clearing price will be one which appropriately compensates original investors for the current value of their investment with appropriate liquidity and future risk discounts and at the same time allows the purchaser to make a reasonable risk-adjusted return on invested capital. While it is early to tell if this market will, in fact, continue to develop at the current course and speed, all signs are that it will, and its continued expansion will change the way private equity portfolios are managed in the future.

The History of the Private Equity Secondary Market

Other classes of assets including commodities, debt, public equity and real estate began as solely primary markets, and as those primary markets began to mature, a secondary market emerged for each asset class which, over time, eclipsed the primary market in size, scale and turnover. The secondary market for public equities is \$37 trillion (not including derivatives), thousands of times the size of the initial (or primary) market as measured by IPOs and follow-on sales. The same holds true for all of the other asset classes, and generally speaking, the more mature the asset class, the more robust the secondary market. Because private equity investments have, by definition, a limited life, the secondary market for private equity will never achieve the same multiple of size that applies for public equities. At the same time, while private equity markets

are newer asset classes, the trajectory of the secondary market is, as one would expect – up and to the right.

While the PESM has been ‘around’ for over 20 years in one form or another, historically it has been stigmatized with a reputation of being a market of ‘last resort’ that would only be used by an institution in distress or a sketchy LP. Reflecting this bad rep, asset pricing was usually a fraction of Net Asset Value (NAV) and transactions have historically been small in both number and value. Beginning around 2004, however, the PESM started to become more efficient with greater liquidity which attracted additional product, beginning a virtuous cycle that continues to this day.

The PESM has grown from approximately \$6.4 billion in 2004 to an estimated \$18 billion in 2008, a compound annual growth rate of 30%.¹ It is expected to reach \$20 - \$30 billion per year in the next two to three years according to Lexington Partners.² In a recent article, Bloomberg was even more aggressive in saying that investors ‘may increase so-called secondary sales of private equity funds to more than \$100 billion during the next year’.³ That would represent almost 10% turnover of the \$1.2 trillion of private equity interests, up from 1% turnover in 2006, but still nowhere near the turnover of the public equity secondary market. Reflecting this wider acceptance of secondary sales, SecondMarket, a web-based platform secondary market maker for private equity, auction rate security, bankruptcy and other positions has experienced rapid growth over the last 18 months. On its website, SecondMarket claims to have cleared over \$2.2 billion in transactions between April 2008 and September 2009. The historical stigma that was associated with secondary sales has been replaced with the recognition by major players having

strong reputations that the secondary market is an effective tool to actively manage a private equity portfolio.

Advantages to Limited Partners

Institutional investors in private equity have more reason today than ever to be seeking active portfolio management solutions. The PESM is a valuable tool to rebalance portfolios by manager, sub asset class, vintage year, industry and geography which has historically only been possible by modifying new commitments. With ten year fund lives that take up to 15 years to liquidate, large LPs may find that they have over 100 relationships to manage, many of which may be dormant (eg. capital is fully called down, the manager has decided not to raise another fund, or the LP has decided that it will no longer invest with the manager). These dormant or inactive relationships are expensive to administer for the LP, particularly as many of them are older commitments made when fund sizes were smaller so that the ratio of administrative cost to committed capital is especially punitive. The secondary market allows the realignment of capital from inactive to active GP relationships. Finally, LPs may also find that they want to rebalance a portfolio when a new manager comes in and inherits a portfolio that is inconsistent with their investment strategy. Rather than pollute their own returns, they may prefer to sell the legacy assets and start with a clean slate.

Last year's substantial declines in public markets triggered the well characterized 'denominator effect' where strict asset allocation guidelines are violated by collapsing prices of liquid assets (the denominator). A 2007 allocation of 8% to private equity may have become 15% or more by March, 2009 without any new private equity investment. The denominator effect is compounded

in the portfolio of large endowments like Harvard and Yale by the need to distribute cash to the Universities to meet operating requirements in an environment where the absolute return on the endowment is negative and the dampening effect that the economic crisis has had on alumni giving. For endowments and other institutional LPs, secondary sales of private equity interests also helps preserve future cash by avoiding investment of uncalled capital. At the same time, despite the pressure to sell, the cold realities of the marketplace may be cause for reconsideration. Harvard announced last year that they were selling \$1.5 billion of their holdings in LBO funds, only to find that market bids were significantly below what they anticipated. Harvard ended up selling far less than they had initially intended. Similarly, Stanford contemplated selling up to \$1 billion of their private equity portfolio but ultimately decided not to go to market.

Thoughtful utilization of the PESM also allows LPs to time-shift their private equity commitments. Limited partners in LBO funds during the ‘bubble years’ of 2005 – 2007 which are likely to have poor returns can sell those commitments in the secondary market and deploy fresh capital in funds that are beginning to invest now and can take advantage of lower pricing, thus avoiding the opportunity cost of keeping a fund that is expected to return 2x invested capital five years from now by trading it for one that is expected to generate a significantly higher return eight years hence.

The PESM can also be used to manage residual assets in more mature private equity holdings. If a fund has already returned 3 – 5x on exits and the remaining companies represent only 30% of invested capital are expected to return 2x NAV, and that not for a few years, the LP may be

better off selling the balance of that portfolio in the secondary market where they can redeploy that capital in presumably higher yielding investments while gaining significant administrative burden relief with minimal impact to the overall fund return.

For institutional Limited Partners, the historic practice of ‘fire and forget’ has given way to a much more strategic use of the secondary market as way to rebalance portfolios, manage GP relationships, time-shift market commitments and eliminate ‘long tail’ residual fund management. There are different but equally compelling advantages for General Partners to use the secondary market.

Advantages to General Partners

Just as LPs may want to jettison dormant relationships, GPs can replace inactive LPs with active ones by allowing an LP to sell their fund interest in the secondary market. At a minimum this can revitalize the LP/GP relationship in qualitative ways. Through the use of a ‘stapled transaction’ where the secondary purchaser commits to investing fresh capital in a new fund, the GP can augment its fundraising as well. A secondary purchaser may also offer (or insist on) co-investment rights which strengthens the GPs leverage in current and new transactions.

GPs who sell direct investments in their portfolio companies (direct secondaries or synthetic secondaries) can benefit in several ways. Many 1999 and 2000 funds are reaching their end-of-life, and LPs are loathe to grant extensions of to fund life, as they want to cull these relationships from their portfolio (as described above) and repatriate any cash that may be coming from sale of the portfolio or claw backs from the general partners. Since the exit market for venture capital in

particular has been virtually nil for the last few years, many LBO and venture portfolios from these vintage years (and into the future) are stuck with several companies in their portfolio that can neither go public nor be sold in an M&A transaction, and the serious constipation of the exit market has meant that these ‘tails’ are often of significant size. LPs do not want their GP relationships to distribute this private company (or in some cases, illiquid public company) stock to them. The PESM offers a way for GPs to sell these tail end fund portfolios so that they can distribute cash to the LPs.

Finally, in some cases LPs may be willing to allow end of life GPs to continue to manage a portfolio, but deny them annex funds or continuing management fees. These GPs may be able to sell selected portfolio companies and recycle that cash either in follow-on investments into other portfolio companies or use the resulting cash to pay ongoing management fees.

Advantages to Corporate/Financial Institution Funds

Many corporations and financial institutions entered the private equity business for strategic and financial reasons over the past several years. A lot of those same participants have decided to exit the LBO and venture capital business for similarly strategic and financial reasons. The secondary market gives these institutions the ability to sell their entire portfolio of investments to shore up their capital ratios and refocus on their core businesses. Some secondary portfolio purchasers will hire the portfolio managers, solving a HR problem for the selling entity as well. Finally, given the significant declines in the market, there can be substantial cash flow advantages that result from unlocking the tax benefits of unrealized capital losses in these portfolios.

Advantages to Companies

In direct secondaries (where one GP sells stock in a company directly to a new GP), there are several potential advantages to the portfolio company involved in the sale. Sometimes, early investors have lost interest in the investment, either because the partner who made it has left the fund, the portfolio company sector is no longer one the fund is interested in, or the investor is simply ‘burned out’ on the portfolio company. Often this leads to conflicting interests between the tired GP and the other investors, board members and management. One voice is lobbying to sell the company or cut costs to prevent additional capital calls while the other voices around the table want to hold the investment because they see significant value appreciation in future years. By selling to a secondary buyer, the tired GP not only realizes immediate liquidity, but allows the company to bring in a fresh investor who has the interest, patience, and (maybe) additional capital to help the company achieve its goals.

A second potential benefit to portfolio companies is keeping the shareholder base small. An ‘end of life’ GP could distribute stock to its Limited Partners, which could number in the hundreds, complicating shareholder communication and potentially tripping ‘public company’ reporting requirements.

Advantages to Private Equity Secondary Fund Managers and Limited Partners

There are several distinct advantages to private equity secondary fund General and Limited partners. Amassing a large number of companies in a secondary portfolio diversifies risk, and once a basis of a portfolio is established, additional companies and/or portfolios can be added for

further risk diversification. Portfolios can be constructed to either emphasize or diversify away from a variety of concentrations, including sub asset class (buyout, venture – early/late, mezzanine, real estate, energy and infrastructure), geographic (country or region specific, developed and developing world), industry exposure, investment theses, vintage year and maturity. How the secondary portfolio is structured is a function of the investment manager's strategy and appetite for risk.

Secondary market pricing tends to follow overall market pricing, often with a lag. The market moved from pricing at parity (or in some cases a premium) to NAV in early 2008 to substantial discounts to NAV in early 2009, returning to a moderate discount to NAV the second half of 2009. Cogent Partners, a major advisor to the secondary market, estimates that overall pricing fell in the last quarter of 2008 to 61% of 9/30/08 NAV, falling further to 39.6% of NAV in the first half of 2009 and then recovering to 72% of NAV in the second half of 2009.⁴ Part of this recovery was an absolute increase in prices paid for secondary offerings, and part was due to the continuing markdown of NAV as the realities of the worldwide economic slowdown reflected in carrying values of companies and portfolios.

Conclusion

The private equity secondary market is poised for explosive growth due to a confluence of conditions including the maturing of the primary market, the need for active portfolio management by limited partners, the problems associated with tail-end fund portfolio management by general partners, the jettisoning of private equity funds by corporate and financial institutions, and the benefits that can accrue to well constructed secondary funds.

While the growth in transactions has been real, it will only continue if portfolio sellers believe that they are being fairly compensated for their investments and buyers of these positions can generate returns in excess of their cost of capital. That remains to be seen.

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¹ The Private Equity Secondaries Market, PEI Books, Edited by Campbell Lutyens

² FT.com, Secondaries market sees activity rise, 8/10/08

³ Bloomberg.com 'Harvard-Led Sale of Private-Equity Stakes Hits Values', 12/1/08

⁴ Cogent Partners 'Secondary Pricing Trends & Analysis, January 2010'