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BVCA Research Note

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The Private Equity Secondary Market

In what has been a significant period of change, we are witnessing what could potentially be one of the toughest times for governments in living memory across the globe. The financial markets are struggling to see the light at the end of the tunnel (which indeed could be an oncoming train), and the private equity industry has suffered alongside other asset classes. However, one niche area of the asset class, namely secondaries, has seen an unprecedented surge in activity.

The growth of the secondary market

The market has dramatically evolved since Coller Capital raised Europe's first secondary fund in 1994. The primary private equity market, according to some sources, has raised in the region of $1.5 trillion in the last six years, and the secondary market has grown in line with the primary market. The main secondaries players including Adams Street Partners, Coller, HarbourVest, Pantheon and Paul Capital have approximately $70 billion in funds under management. Fifteen years ago private equity was a much more illiquid investment than it is today and indeed, Peter Wilson, managing director at HarbourVest, described private equity at that time as being, "A desert – you could not trade out." Mr. Wilson noted that in those days there had been a stigma associated to secondaries, with some onlookers seeing the shedding of commitments as an admission of failure. That stigma is now a thing of the past and the secondary market is increasingly being used by investors to mitigate the J-curve and spread distributions more evenly, as secondaries tend to invest in mature funds and see faster returns. An estimated $80 billion to $100 billion of private equity interests of LPs are expected to come to the market in the next 2 years, on the whole as a direct result of the state of the global economy; thus represents around 10% of the capital committed globally to the asset class.

David de Weese, partner at Paul Capital noted how the average annual global value for secondary transactions over the period 2005-2007 was approximately $8-10 billion, although a few larger deals in 2007 may have raised that by $2-3 billion, namely sales by CalPERS and ABN AMRO. With less than $20 - $30 billion of 'dry powder' in all the dedicated secondary funds, there is a substantial imbalance between supply and demand. The excess supply of investment opportunities is a factor driving down market valuations - private equity sellers have in recent months been getting only about 50 cents in the dollar, and in some cases much lower, of the face value of their investments, according to a recent report by Cogent Partners, an investment bank. That compares with more than $1 in 2007 and 80 cents in the first half of 2008.

The demand side of the equation is being addressed by secondary specialists going on the road; Pantheon is aiming for a target fund size close of £3-4 billion. 2007's record fund sizes will be exceeded, with at least two firms now seeking to raise $6 billion and several others looking for $3-5 billion apiece. Most secondary specialists agree that there needs to be around $25 billion raised by the end of the year to absorb some of the excess supply of opportunities in the market.

Why are LPs selling?

Secondary market sales activity has been driven by a number of factors:

- **Denominator effect** - As the value of different asset classes falls, for example stocks and bonds, the value of allocations to other assets, including private equity, rises above allocation targets, triggering sales of PE commitments.
- **Valuation volatility** - The highly volatile state of public markets has meant that GPs have difficulty marking their assets to market, causing LPs to become more risk averse, which has led some to sell their commitments in an effort to gain greater stability.

- **Geared strategies** - Vendors may be facing balance sheet distress due to insufficient liquidity for instance, forcing the sale of commitments to meet repayments on other investments or general business functions. Some family offices are being driven to sell, as they often use leverage to maximise returns, but some are now getting calls on these bank lines they cannot meet, as capital coming in from exits has plummeted. These LPs are off-loading some assets in response. In turn, banks are facing an increased cost of capital to hold private equity assets causing them to rethink their holdings.
- **Portfolio management** - In the current state of economic uncertainty, LPs may be refocusing on core investments and look to rebalance their portfolio, relinquishing investments in private equity.
- **Uncalled commitments** - LPs may wish to surrender commitments to uncalled capital, to redefine their investment strategy. Many LPs want their capital to be used quickly, to avoid exacerbating the J-curve. Some other LPs are frustrated at the lack of distributions now that exits have ceased to be viable at the time being.
- **Over-commitment** - Due to reduced distributions, some LPs find themselves over-committed to funds; the slowdown in the market means they can no longer rely on recycling distributions returned from earlier investments to support their later commitments.

What does the future hold?

Mr. Wilson noted that the value of investment opportunities in the secondary market was priced at $30 billion in 2007 and $59 billion in 2008. In '07 one-third of deal flow was from financial institutions; in 2008 half of that was from financial institutions, signifying a 3 times increase in money terms. However, there is only a fraction of activity that is actually closing. Partner at Pantheon, Paul Ward, opined that investment opportunities in the secondary market are currently strong, but the misalignment in prices between vendors and purchasers means that completed transactions will not significantly rise until spring or the second half of this year, with buyers currently offering 60% - 80% of prices demanded by vendors; more realistic valuations on the part of vendors will go some way to rectify this issue.

LPs have had a headache in pricing accurately because they have different forecasts for 2009 due to the volatile economy and its impact on GP portfolio companies. Greg Holden, partner at Adams Street discussed how this has lead to a flight to quality, as LPs focus on acquiring interests with GPs whom they feel are more likely to weather the tumultuous state of the economy. It is merely a matter of time before we see the volume of transactions accelerate. This will cause pricing to be much more transparent as the discount to NAV on which trades are made may make GP performance more visible, as better performing GPs will see smaller discounts compared to lower quartile GPs.

In the latter part of last year, the decision by Permira to allow investors to not meet capital calls, subject to penalties, was something of a one off to provide a get out for LPs with liquidity problems; it is in GPs' interests to be sympathetic to the situation of their investors, but ultimately GPs need capital to invest. Secondaries offer a positive solution for a GP in the sense that they allow for the replacement of a distressed LP or one not committed to the asset class in the future. And when looking to raise new funds, once GPs are able to isolate weak LPs and adjust their LP base, going on the road will become more efficient and effective and the chance of re-ups will be heightened.

The secondary market is a specialist area. It assists GPs with access to long term capital; provides guidance with regards to best practice (for instance valuations); and fosters stability and additional investment, due to the ability of secondaries to make direct investments into subsequent funds. Additionally, secondaries can sometimes potentially create a better relationship with an LP than a primary manager as secondary transactions require heavy due diligence on both sides which can create a deep and useful relationship. This will help the private equity industry to survive and thrive in the future.

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