RISE OF THE PRIVATE EQUITY SECONDARY MARKET AND BENEFITS OF A DEDICATED ALLOCATION

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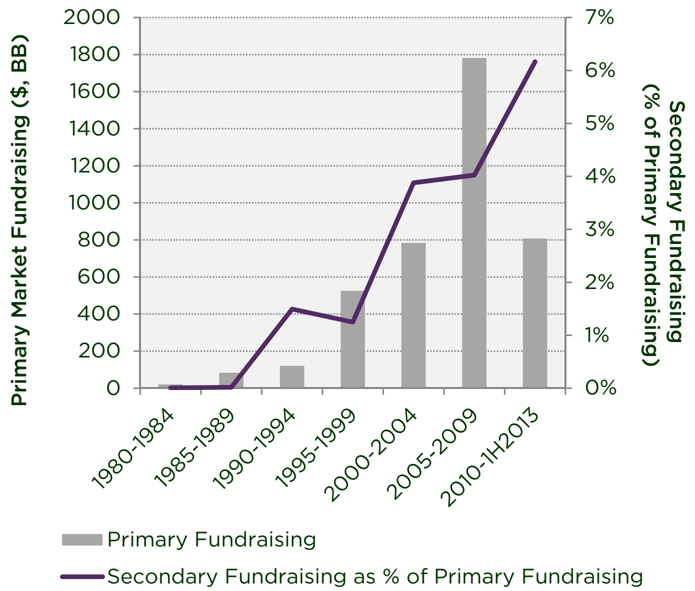
The secondary market for private equity dates back to the early 1980s when the first dedicated secondary firms, Venture Capital Fund of America and Landmark Partners, were formed exclusively to purchase private equity interests from limited partners (LPs) under distress. The secondary market remained on the fringe of the institutional investment landscape throughout the '80s but gained traction in the early '90s, buoyed by massive growth in the primary private equity market and regulatory changes for banks and insurance companies. From 1985 to 1989, funds in the primary market raised an aggregate $84 billion, a four-fold increase from the first half of the decade.[1] Secondary market demand grew as a byproduct once those primary fund interests began maturing. During the '80s, secondary specialists raised less than $20 million in total; however, from 1990 to 1994, secondary funds raised nearly $2 billion and that number more than tripled over the subsequent five years.[1] A number of new investors began raising dedicated secondary funds during this period including global secondary specialists, primary fund of funds managers and investment banks.

The primary market continued its rapid ascent, peaking with the buyout boom in the mid-2000s. Primary funds raised around $1.6 trillion during the four-year period from 2005 to 2008, more than the aggregate $1.5 trillion that had been raised over the previous 25 years combined.[1] Primary fundraising dropped off considerably immediately following the financial crisis but has since rebounded, albeit to levels that are still well below the buyout boom's peak years. From 2009 to 2012, primary funds raised $820 billion, or about half the amount raised during the preceding four years.[1]

Exhibit 1 - Growth in fundraising primary vs. secondary markets



Sources: Thomson Reuters, September 2013; Dow Jones, May 2013

The secondary market grew at an even faster pace than its primary counterpart as secondary sales garnered greater acceptance among institutional investors. Secondary funds raised about $8 billion during the '90s, which equaled 1.3% of the capital raised in the primary market.[1] That ratio increased to around 4% during the subsequent decade as secondary funds raised more than $100 billion in total.[2] Over the past several years, the amount of capital flowing into the secondary market has continued to grow relative to the primary market as the immense overhang from the buyout boom created an abundance of opportunities for secondary investors.

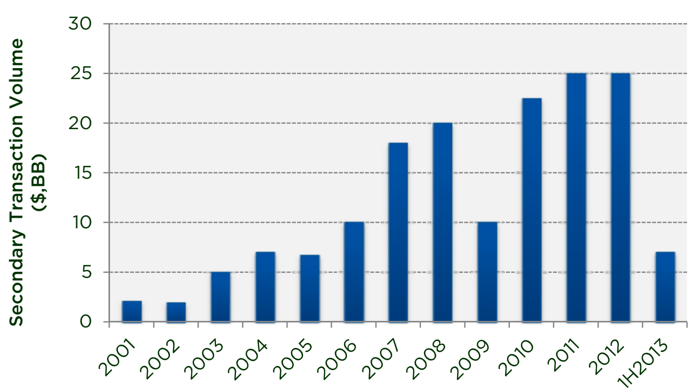
1 - Thomson Reuters, Thomson ONE, September 2013
2 - Dow Jones Guide to the Secondary Markets, 2013 Edition

Changing Landscape

In its early days, the secondary market was used almost exclusively as an exit of last resort for distressed LPs strapped for liquidity. Transaction volumes were inconsistent and a lack of specialized intermediaries required buyers and sellers to seek out one another, making the market extremely inefficient. Additionally, there were a relatively small number of secondary funds active in the space, which allowed those funds to purchase interests at substantial discounts to their net asset values.

Over the past decade, market efficiency has improved dramatically, supported by a flood of capital into the space, a large increase in the number of buyers and sellers, and the rise of specialized intermediaries, such as Cogent Partners, to broker secondary transactions. The improved efficiency has driven down typical purchase price discounts, but has created a mature, competitive secondary market with sustained deal activity and sizeable transaction volumes. Secondary transaction volumes have reached at least $10 billion each year since 2005, setting new records each year from 2010 to 2012.[3]

Exhibit 2 - Increased secondary transaction volume



Sources: Cogent, September 2013

Historically, the secondary market was viewed primarily as an opportunistic market associated with financial distress, but the maturation of the market has changed the nature of its use by institutional LPs. For institutional LPs, there was once a stigma associated with selling interests on the secondary market. However, that stigma has mostly disappeared and LPs now regularly use the secondary market for a variety of reasons knowing they can receive competitive pricing. A Dow Jones recent survey showed that LPs are selling interests on the secondary market primarily for portfolio management purposes or due to regulatory changes rather than as a result of financial distress.[2]

Throughout most of the ‘80s and ‘90s, secondary deals were almost exclusively structured as one-off, plain vanilla purchases of single fund interests. As the market matured and secondary specialists gained experience and expertise, the type and structure of deals expanded. Today, secondary deals often involve portfolios of fund interests, which have reached individual deal values of more than $1 billion. Structured transactions, which involve unique economic arrangements rather than the complete sale of an interest, also have become common practice. In a typical structured transaction, a secondary specialist will work with an LP that would like to be relieved of the burden of uncalled capital but does not want to sell the interest at a discount. Secondary specialists often will agree to fund remaining capital calls in exchange for a negotiated portion of future distributions. Additionally, so-called synthetic secondaries have gained in popularity in recent years. A synthetic secondary can take many forms but generally involves the formation of a new limited partnership by a secondary specialist for the specific purpose of purchasing a portfolio of direct investments. The secondary specialist will either hire a new management team or the incumbent to oversee the sale of the assets.

A Dedicated Allocation?

Many institutional investors view secondary funds solely as opportunistic investments, making commitments only during or immediately following periods of financial market distress. Intuitively, this makes sense as secondary buyers should be able to negotiate steeper discounts during periods of elevated uncertainty and tight liquidity. An analysis of the numbers supports this notion. In a sample of 62 mature secondary funds raised from 1990 to 2008, funds raised in the three-year periods following the recessions of 1991 and 2001 have an average net IRR of 21% while the remaining funds have an average IRR of 14%.[4] However, there are many reasons for investors to consider a dedicated allocation to secondaries, which requires regular commitments to secondary funds.

Mitigates the “J-curve” – Primary private equity investments tend to follow a performance pattern known as the

3 - Cogent Partners, September 2013
4 - Pavilion Advisory Group, Internal Research, September 2013

"J-curve", whereby returns generally are negative in the early years of a fund's life as the commitment is drawn, fees are paid and portfolio investments have not yet matured. Secondary funds mitigate this effect by producing immediate returns through the purchase of mature interests at discounts to NAV. Investors should be aware that many primary fund of funds managers will combine secondary interests with their primary portfolios to mitigate the J-curve. Therefore, LPs that primarily invest in funds of funds may already have a small allocation to secondaries, which should be taken into account when considering a dedicated secondaries allocation.

Less Blind Pool Risk – One of the risks associated with private equity funds is blind pool risk, which arises from the fact that an LP is making a commitment to invest capital in a portfolio that has not been built yet. Secondary investments significantly reduce this risk because the secondary specialists are purchasing interests in portfolios that generally are more than 50% invested and have less unfunded commitments. Therefore, there is an actual portfolio of companies that the secondary specialist is able to evaluate.

Shorter Duration – Mature secondary investments essentially cut off several years from the typical term of a private equity fund because a good portion of the investment period already has been completed at the time an interest is purchased. Therefore, secondary investments generally distribute cash back to the investor more rapidly than primary investments. This may be important to institutional investors with liabilities with an ability to assume some illiquidity risk, but would like to limit to the extent possible the duration of that illiquidity risk.

Diversifies Private Equity Program – While it takes time for an LP to build an adequately diversified primary private equity program, an allocation to secondaries can provide instant exposure to a highly diversified portfolio of mature private equity interests. Additionally, secondary investment returns are determined partially by secondary market pricing dynamics that do not impact primary fund returns.

Lower Probability of Poor Performance – The potential upside for secondary funds is not as high as that of primary funds, but secondary funds produce poor returns much less frequently. Only two out of 62, or 3%, of the sample of secondary funds raised from 1990 to2008 produced negative IRRs compared to nearly a quarter of primary buyout funds and almost half of primary venture capital funds raised in that time frame. The worst IRR produced by a secondary fund in the sample was -4.4% while more than one out of every ten primary buyout funds and a quarter of primary venture funds produced an IRR below -4.4%. Additionally, secondary funds have produced an average IRR of 15.3%, significantly better than the averages of 10.3% for primary buyout funds and 9.7% for primary venture funds, driven by the quicker pace of distributions for secondary funds. Primary funds have produced marginally better average total value multiples, 1.50x for buyout funds and 1.56x for venture funds versus 1.48x for secondary funds, but the primary fund averages are skewed upwards by a small proportion of funds with extremely high multiples. More than 80% of the sampled secondary funds produced a total value multiple of at least 1.25x compared to just 57% of primary buyout funds and 37% of primary venture funds.

Exhibit 3 - Comparison of funds raised 1990-2008

	TV/PI		Net IRR	
	Secondary Funds	**Primary Funds**	**Secondary Funds**	**Primary Funds**
Best	2.55	28.04	44.5%	721.0%
Top Quartile	1.63	1.69	19.8%	12.8%
Median	1.42	1.19	14.0%	3.2%
Bottom Quartile	1.27	0.86	8.2%	-2.4%
Worst	0.88	0.00	-4.4%	-100.0%
Average	1.48	1.52	15.3%	9.8%

Sources: Pavilion Advisory Group; Internally gathered sample of 62 mature secondary funds raised from 1990-2008 & Thomson Reuters, Thomson ONE; Includes 926 LBO funds and 1,473 VC funds raised from 1990-2008

Conclusion

With unprecedented growth in private equity over the last couple of decades, the secondary market has transformed from a niche, seldom used market to an efficient, competitive market that is widely accepted by institutional investors. Limited partners now regularly use the secondary market as an important portfolio management tool rather than as an exit of last resort. As a result of its growth and increased acceptance, the secondary market has reached a sufficient size to support a dedicated allocation as part of a broader private equity program.

There are many reasons for investors to consider a dedicated allocation to secondaries, from shortening duration to increased diversification to decreased chances of poor returns. Many LPs view secondary funds as opportunistic investments, similar to distressed debt funds, investing only during periods of financial market distress. Investors with a dedicated allocation can make tactical decisions to overweight secondaries during periods of distress. Additionally, a dedicated allocation can allow an investor to maintain exposure at all times, including periods of unforeseen opportunity.

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