iCapital

SECONDARY PRIVATE EQUITY FUNDS

DIVERSIFIED PRIVATE EQUITY EXPOSURE WITH AN ATTRACTIVE RISK PROFILE

The secondary private equity market comprises the buying and selling of preexisting investor commitments to private market funds.

Secondary funds (secondaries) purchase these existing commitments from limited partners (LPs) seeking to exit primary private equity funds before they are fully liquidated. In recent years, the secondaries segment has grown and matured, and may offer significant appeal to investors.

AN ACCESSIBLE ENTRY POINT INTO PRIVATE MARKETS

Secondaries offer several potential benefits for investors and may represent a particularly attractive entry point relative to primary private equity funds because of their unique risk and return characteristics.

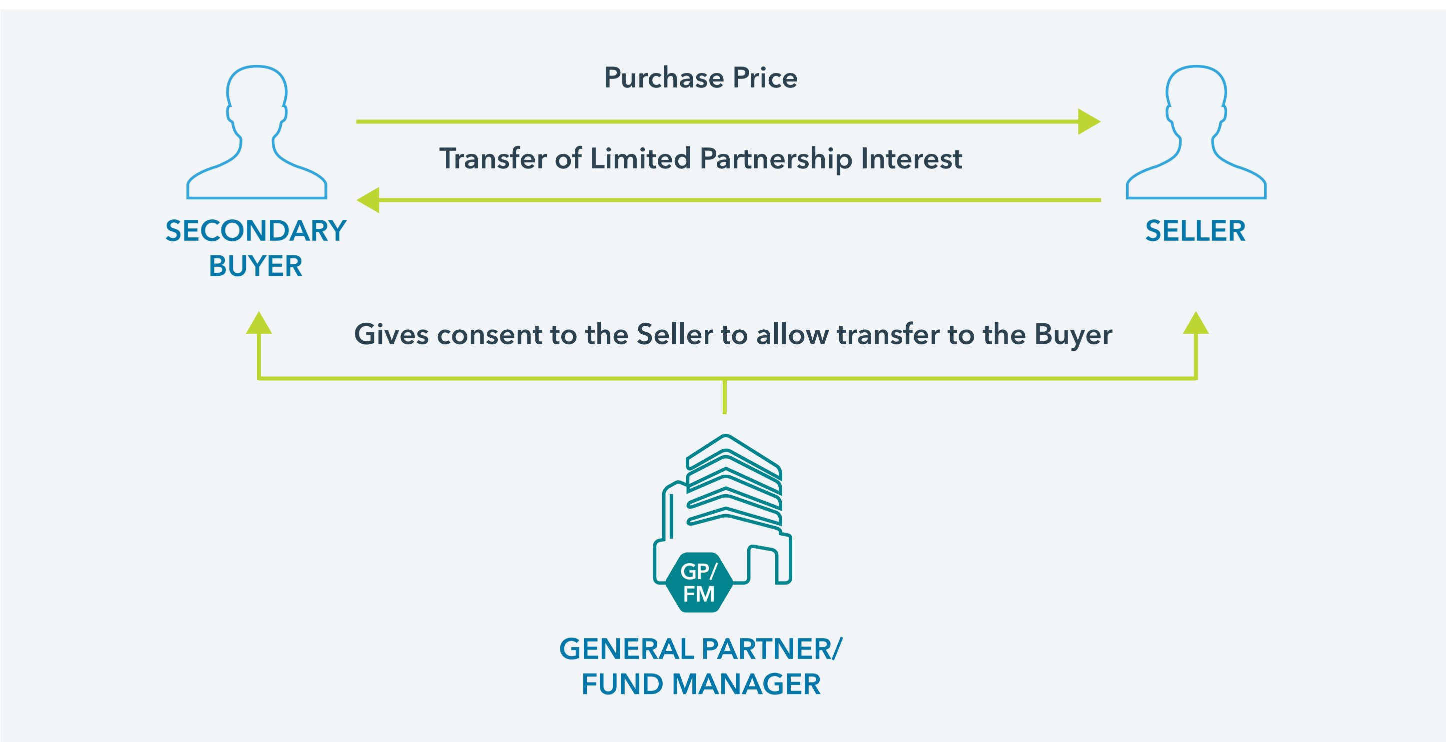
Diversification

Secondary funds are typically more diversified than primary private equity funds (such as growth equity or buyout funds) because they assume preexisting commitments in multiple funds. As such, secondary funds may offer significant diversification across managers, industries, geographies, strategies, and vintage years. This diversified approach has the benefit of offering private equity exposure with less risk compared to an investment in a single primary private equity fund.

Shorter duration and faster return of capital (mitigated J-curve):

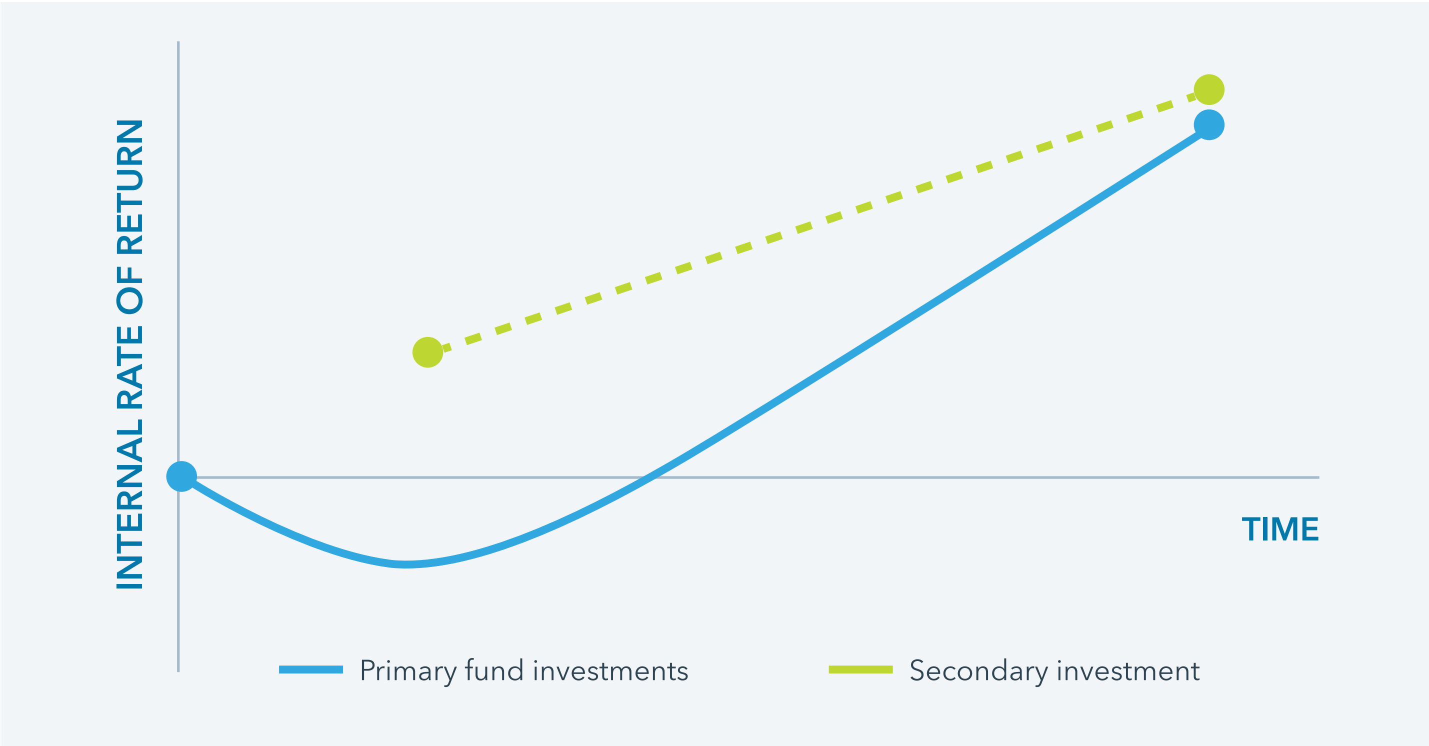
In primary private equity funds, it typically takes five to six years to deploy capital, and it can be several years before investors start receiving distributions. By contrast, secondary strategies deploy capital faster and distributions typically begin quickly—in some cases as soon as the fund's inception—because they are

Exhibit 1: An Overview of Secondary Transactions and Participants



Source: Capital Dynamics. *For illustrative purposes only*

Exhibit 2: Typical Return Patterns of Primary and Secondary Private Equity Funds



Source: iCapital. *For illustrative purposes only*

investing in mature underlying funds. This mitigates the private equity J-curve, in which primary private equity funds typically have "negative" returns in the first few years (as investors have to pay management fees and initial investment costs from day one), that then turn into positive returns as the underlying investments mature. At this point, funds typically start to generate returns that may significantly outweigh the fees and expenses. Exhibit 2 illustrates the typical return profile of a primary private equity fund versus a secondary fund.

Discounted access to private equity funds

The ability to exit private equity funds early has historically come at a price to sellers—secondary fund managers would buy preexisting interests in funds at a discount to their net asset value (NAV). As the market grew more competitive in recent years, that discount declined (in 2019, however, secondary portfolios still traded at an average of 93% of NAV).[1] This trend is expected to potentially reverse following COVID-19-driven market volatility. Secondary investors would benefit immediately from this discount as well as any value creation that takes place subsequent to the investment.

Limited blind pool risk

Investors in primary funds don't know in advance what investments the fund manager will make. This is known as blind pool risk. Secondaries mitigate blind pool risk by investing in existing commitments. In other words, they know which assets they are acquiring before they invest, enhancing the potential for due diligence and providing visibility into potential future performance.

AN EVOLVING AND INCREASINGLY SOPHISTICATED MARKET

Secondary investments initially emerged as a simple mechanism for providing liquidity to constrained LPs. This was a niche market characterized by few buyers, stressed sellers, and steeply discounted prices. As the market has matured, however, it has seen an increase in the sophistication and diversity of its participants. As Cambridge Associates noted in their 2020 market overview, "secondaries are no longer relegated to the kids' table."[2]

Today, institutional investors use the secondary market to actively manage their private equity portfolios. Accessing the secondary market is often less about gaining liquidity and more about a strategic realignment of an institution's portfolio. Secondary transactions can help investors reduce their number of general partner (GP) relationships, meet regulatory changes that require a reduction in private market exposure, and address asset allocation shifts at the direction of their investment teams.

The secondary market has also seen more diverse, sophisticated entrants, including pension funds (led by large Canadian pensions[3]), sovereign wealth funds, family offices, endowments, and foundations. Such participants increase overall market competition and may reduce the discount at which interests change hands, while being able to operate at a lower cost of capital compared to traditional secondary private equity funds/buyers.

The market's intermediary channel has also expanded significantly. Secondary advisory firms are now available to help price portfolios, identify buyers and sellers, structure transactions, manage data rooms and NDAs, and collect and negotiate offers.

Additionally, more general partners (GPs) are turning to secondaries to provide liquidity for their existing LPs. This allows investors to liquidate their positions in older vintage funds and GPs to achieve goals such as bringing in investors with a different time horizon or holding an asset that well exceeds a fund's term but where additional time and perhaps new capital may allow the GP to create additional value. Such GP-led deals are becoming an increasingly important part of the secondary market. In 2019, they accounted for $25.7 billion of transactions (a 25% jump from the prior year).[4]

FUELED BY PRIVATE EQUITY'S EXPANSION

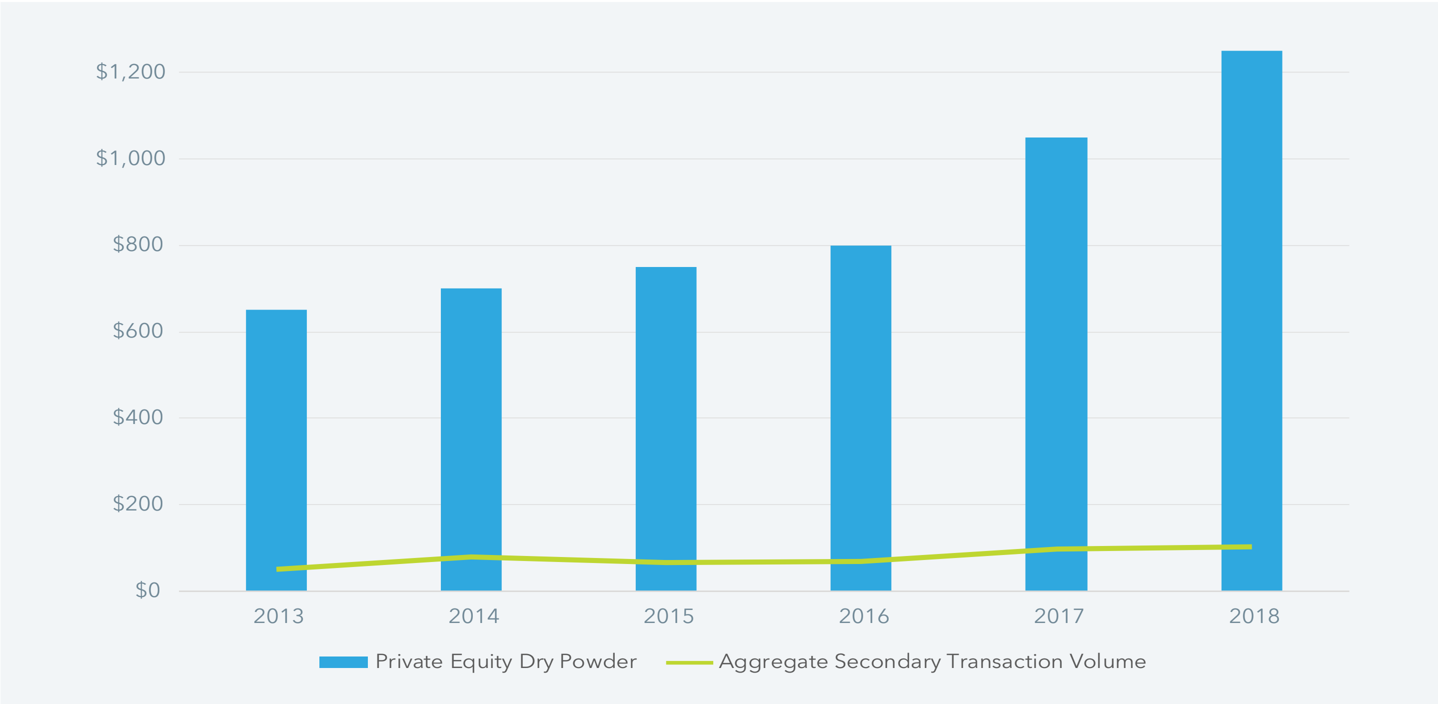
Rapid growth in the primary private equity market has increased the total volume of assets available to be resold as secondaries. This has fueled growth of the secondary market: Since 2010, secondary volume has more than tripled.[5] 2019 estimates indicate that market transaction volume reached approximately $80 billion[6] last year–achieving a record high for the third year in a row. Despite this growth, secondaries' share of overall private equity transactions remains very low, having slightly increased from roughly 1%-4% of private market commitments in 2009-2016 to 6% in recent years.[7]

Secondary activity, however, is likely to slow in 2020. As of March 2020, secondary market volume has declined as both buyers and sellers wait to adjust to pricing expectations and underlying portfolio re-valuations in light of COVID-19-driven economic weakness (with the secondary markets therefore acting with a longer lag than the primary markets). Similar to other periods of volatility such as the Global Financial Crisis (GFC), the bid-ask spread is likely to remain wide for at least several quarters before recalibrating. GPs, however, are already seeing attractive opportunities driven by stressed sellers, as well as in GP-led secondaries, which represent a much larger part of the market today than during the GFC.

THE STATE OF THE MARKET: CHALLENGES AND OPPORTUNITIES

One upside of the recent market volatility is that pricing levels in the secondary market are expected to potentially adjust downward, leading to a more attractive buying

Exhibit 3: Private Equity Dry Powder and Secondary Transaction Volume



Sources: Preqin Secondary Market 1H 2019 and 2020 Preqin Global PE & VC Report. For illustrative purposes only.

opportunity for secondary fund managers. The secondary market was previously trading at all-time high levels, with large buyout funds being sold at a record-high 100% of NAV.[8] These elevated pricing levels were leading to compressed return expectations. Going forward, a downturn-driven reset will instead see the secondary market readjust to lower valuation levels, enabling secondary fund managers to purchase positions at greater discounts. In all market environments, those managers who have success in identifying assets outside of competitive auctions or in proprietary situations–or where they benefit from an information advantage–are likely to outperform.

Another element for investors to consider is that, while secondaries can provide a mitigated J-curve and faster return of capital, the cash flow profile of secondary funds is reliant on distributions. If distributions slow (as they might in today's recessionary market environment), return profiles could lower. Therefore, it is important to select disciplined managers who are keenly focused on downside protection and have a proven track record of navigating market cycles.

For high net worth investors, the secondary private equity market offers several potential unique portfolio benefits. Specifically for investors seeking to gain private equity exposure through a primary fund but concerned about the duration or significant gap between making a commitment and receiving distributions, secondary funds may be an attractive option. As with any private equity investment, manager selection is critical to realize the benefits of these strategies.

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END NOTES

1. Triago Quarterly, October 2019.

2. Cambridge Associates, Outlook 2020: Ten Investing Themes for the Coming Year.

3. Secondaries Investor, “CPPIB, the smartest, nicest guys in the room,” February 2019.

4. Evercore Private Capital Advisory YE2019 Secondary Market, January 2020.

5. Greenhill Secondary Market Trends & Outlook, July 2018.

6.Evercore Private Capital Advisory YE2019 Secondary Market, January 2020.

7. Capital Dynamics based on Thomson One Cambridge Associates data; Greenhill, Secondary Market Trends & Outlook, January 2018.

8. Triago Quarterly February 2019.

IMPORTANT INFORMATION / DISCLAIMER

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