An Evolution in the World of Private Equity

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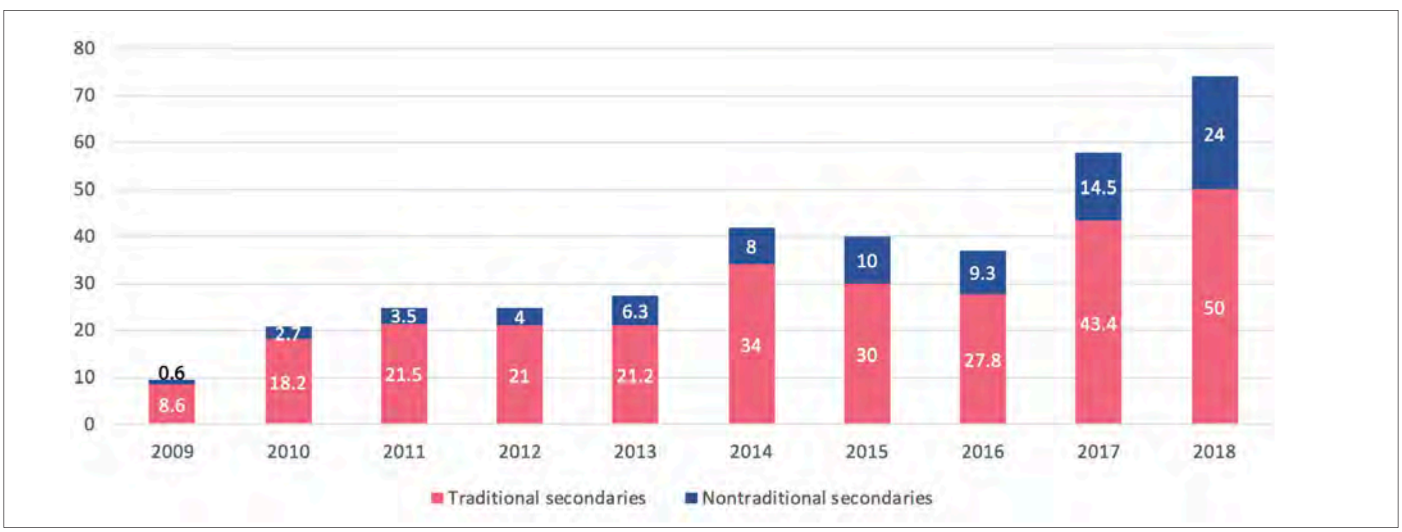
Over the past 20 years, private equity (PE) has grown to about $3 trillion under management globally. Traditionally, investors—called limited partners (LPs)—have mostly gained exposure to underlying companies either via funds (which own companies directly) or funds of funds (which aggregate many PE-fund investments into a single product). Collectively, investment into a PE fund from "day one" is known as the "primary" market. Over the past decade, however, we have also seen growth of the PE "secondary" market, which specializes in buying funds and portfolio stakes secondhand from investors desiring early liquidity in these funds.

The PE market continues to be an inherently long-term and illiquid asset class, as evidenced by an average fund life of 15 years. With the increasing prevalence of secondaries capital in the market, LPs have been able to sell their stakes in private equity funds prior to the end of the fund life. The most common type of secondary deal is known as a limited-partner transaction. A fund investor sells an interest, or a portfolio of interests, to another investor (a purchasing investor) based on a negotiated price, usually as a percentage of net asset value (NAV). The purchasing investor assumes the legal and financial obligations to the underlying fund(s).

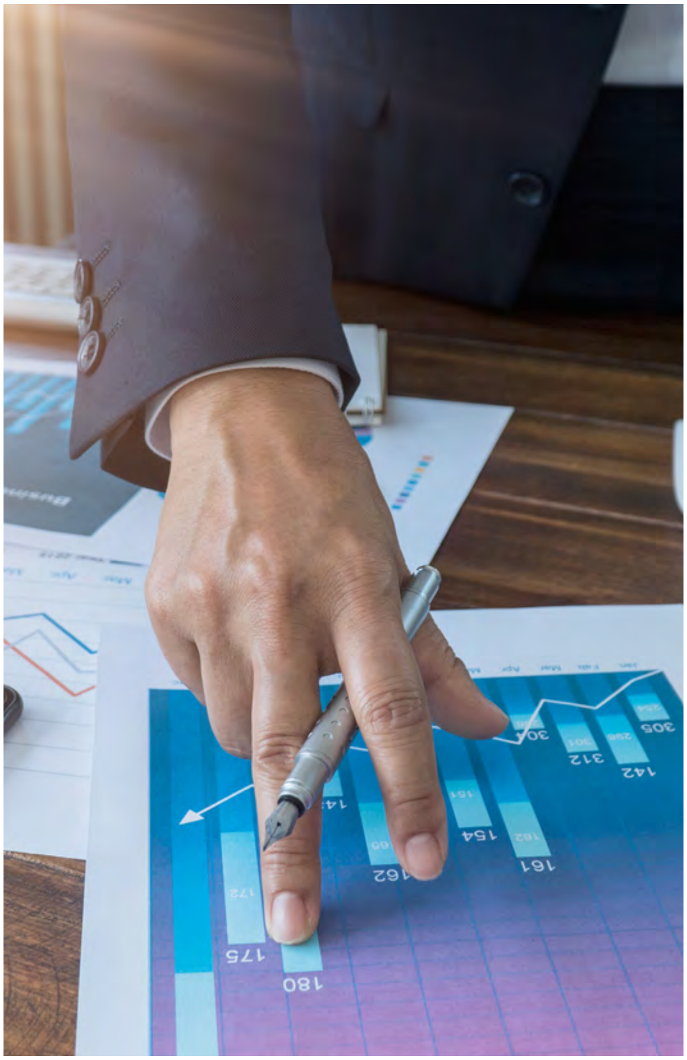
Sellers are usually motivated to undertake these transactions for three reasons: active portfolio management, strategic and regulatory drivers or liquidity-driven situations. Over the past several years, for example, large pension and sovereign-wealth funds and insurance companies have begun to use a more liquid secondary market in order to rebalance exposures and reduce the number of private equity relationships—effectively adopting traditional asset-management techniques to managing their illiquid PE portfolios. Using the secondary market has also become more economically attractive to sellers as the discount to NAV has narrowed in recent years and prices paid on average have increased.

Limited-partnership sales accounted for around three-quarters of transaction volumes in 2017 (see Figure 1). The growth in secondaries really started during the global financial crisis 10

Figure 1
Secondary Volumes at Record Levels (in Billions of Dollars)



Sources: Greenhill & Co., Inc. as of January 2017; Greenhill & Co., Inc. as of January 2019; DWS Investment GmbH as of June 13, 2019.



years ago. Increased scrutiny of large financial institutions, including banks, led to strategic portfolio sales of illiquid and directly held PE assets and underlying PE-fund commitments. Although this part of the market has historically generated attractive opportunities, its prevalence has waned in recent years, as banks have reduced their balance sheets and exposure to private assets. Liquidity-driven or distressed situations can also still occur today but have historically been less common.

Another, increasingly common type of secondaries is manager-led transactions. Managers, called general partners (GPs), might seek liquidity options on behalf of investors for the remaining assets in a fund, while also potentially securing additional time (and sometimes capital) for a portfolio of legacy assets to mature and be primed for sale (usually called an exit). The structuring (or restructuring) of these types of transactions can be complex and time-consuming. Usually, it requires highly bespoke solutions around the composition of the underlying portfolio, the price to sellers and the alignment between old and new investors, as well as the manager. GP-led deals and other nontraditional secondary transactions such as preferred-equity purchases already account for between a quarter and a third of deal volume (see Figure 1). We believe such deals may play an increasingly important role in the future.

Effectively, growth in the secondary market has contributed to somewhat greater liquidity in the PE asset class. The secondary market offers investors in secondaries funds instant access to a highly diversified PE portfolio, providing exposure across vintage years, sectors and geographies, while sellers benefit from an active buyer universe for their illiquid PE positions. However, the secondary market still remains much smaller than the primary market, with less than 2 percent of PE assets estimated to trade hands each year. Its rapid growth reflects structural changes in the market.

We believe there may be ways to get the best of both direct and secondary investing. By focusing on "stock picking" later-stage investments within an existing PE-fund portfolio, new investors may be able to collaborate with a fund manager's (GP's) best portfolio companies. Supporting these companies can ideally satisfy every stakeholder: new investors, incumbent investors, GPs, as well as the underlying portfolio companies. It may also result in higher returns relative to the market, not least by maintaining the key tenets of a secondary transaction (shorter duration and earlier distributions) while tactically identifying individual, attractive assets within an existing PE-fund portfolio.

In recent decades, the secondary market has grown rapidly, with volumes increasing from $9 billion in 2009 to $74 billion in 2018.

The continued evolution of the PE market has led to the development of strategies that offer investors opportunities with investment characteristics that are a blend of direct buyout investing and traditional secondaries. These strategies, which focus on entering assets midhold, can potentially deliver cash returns commensurate with traditional buyout funds but with a risk and liquidity profile associated with shorter-duration secondary strategies. For insurance companies, particularly those with shorter liability durations like property and casualty or reinsurers, such a strategy could provide access to cash flows sooner than a typical PE fund. Strategies focused on entering assets midhold are generally expected to hold assets for two to four years, shorter than a traditional buyout fund's hold of three to seven years, while still generating strong double-digit net internal rates of return (structured). This is based on our analysis of data from public transactions through the first quarter of 2019. ■

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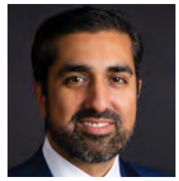

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