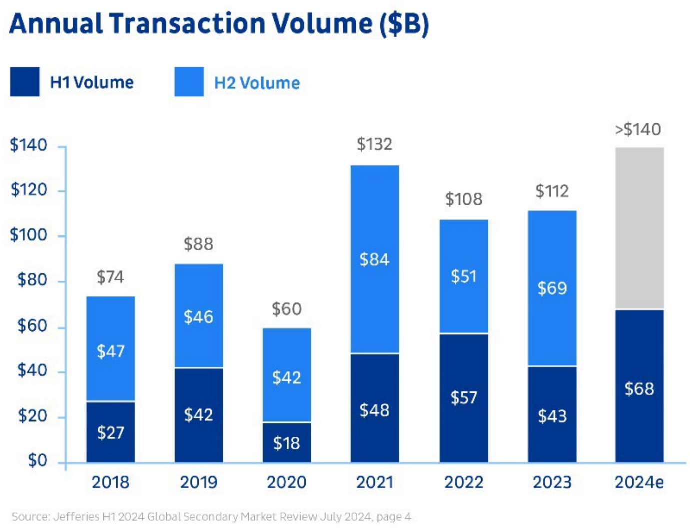
Secondaries | The silent rise of liquidity in the private equity secondary market

Richard Wilmes, Partner & Head of Secondaries at Golding Capital Partners

Translated from German – Initially published in Bundesverband Alternative Investments e.V.

Among the many investment opportunities on offer in the field of alternative investments, one option has stood out for some time: over the years, secondaries have been recording strong and steady growth - with only a brief coronavirus-related interruption. This year could see a new record. Secondaries have registered a steep rise in just ten years: from an access route to the private equity asset class known to only a few investors to a "sub-asset class" in its own right. This comes as no surprise, as the opportunities behind this are a win-win situation for everyone involved.

According to major US investment and financial services bank, Jefferies, an investment volume of USD 112 billion was traded on the secondaries markets worldwide in 2023, making it the second most active year in this market after 2021, when catch-up effects were realised following the abrupt slump caused by the coronavirus pandemic the previous year. In 2022 and 2023, the secondaries markets continued their longer-term growth trend.



According to Jefferies, this trend is set to continue this year: the investment bank recently raised its forecast for this year's investment volume to USD 140 billion.[1]

Secondaries are playing a new role in the alternatives universe

Secondaries were once regarded as a practical expedient enabling investors to exit a private equity fund at an early stage - whether due to their own unexpected liquidity requirements or because the fund's performance had fallen far short of initial expectations. This meant that consequently, the secondary market acquired a reputation (not always justified even then) as being a place where desperate investors could sell funds that had become unwelcome. The discounts on these markets were sometimes correspondingly high.

However, the initial situation has undergone radical change. Secondaries are no longer regarded as an emergency exit, but, increasingly, as an established tool for efficient portfolio and liquidity management for both investors and fund managers themselves. Private markets for physical assets are actually illiquid, but secondaries give them a new liquidity dimension. Years of capital commitment are no longer an automatic prerequisite for entry into a private equity fund. This benefits everyone: potential buyers, sellers and not least, the fund managers themselves. For a better understanding of why this is the case, it is first necessary to differentiate between LP-led [limited partner] and GP-led [general partner] secondaries.

The typical case so far has been LP-led secondaries

The case typical of the secondary market to date, namely the early exit of investors from a fund with the help of secondaries, is commonly referred to as LP-led secondaries - in other words, it is initiated by limited partners or fund investors. LP-led secondaries enable investors to release liquidity or adjust their portfolio strategy at short notice and at an individual fund level.

By way of example, in the initial phase of the interest rate turnaround in 2022/23, they were an important instrument for many investors to reduce relative over-allocations caused by temporary price declines in liquid equities and interest-bearing securities – an effect known as the “denominator.“ Secondaries later made it easier for investors to strategically adjust their portfolio allocation in light of the changed interest rate level.

Further interest rate rises, the lack of traditional private equity sales in a declining M&A market and the resulting lack of dividends to investors also favoured this type of transaction. This in turn led to a decline in the prices achieved: according to Jefferies data, while LP-led secondaries were still priced at an average of 92% of their book value on the market in 2021, the turnaround in interest rates and selling pressure caused prices to fall to an average of 81%, which recently recovered and stabilised at an average of 88%.

Fund managers are jumping on the GP-led secondaries bandwagon

Following the logic of the strong desire for liquidity among investors, fund managers have also learned to make active use of the secondaries market. This is why a counterpart to LP-led secondaries has gained significant momentum in recent years: GP-led secondaries, that is, secondaries managed by general partners or fund managers. Unlike an LP-led transaction, shares in an existing investment fund whose composition remains unchanged do not change hands, but fund managers transfer individual companies from the fund portfolio in part or in full to a new fund vehicle set up specifically for this purpose and managed by them.

For example, a fund manager may want to provide the most attractive private equity companies in a portfolio with additional growth capital beyond the original investment horizon and develop them further. This also allows fund managers to cater to the different interests of their investors: some may opt for an exit at the end of the investment horizon, for instance, to realise any value gains, while others who do not currently require liquidity may recognise continuing future potential in the asset and would consequently prefer to maintain their investment. The transaction price is usually determined in an auction process by secondary market investors and at the same time, external law firms generally prepare an expert opinion on the fair market value of the respective company, so that fair pricing is guaranteed in a transparent process.

A GP-led transaction gives investors the choice of exiting or remaining invested via the continuation fund. These - and any new - investors will be able to benefit from the continued success potential of a well-coordinated team of fund managers and corporate management.

GP-led secondaries emerge from their niche

Over the years, this has enabled GP-led secondaries to progress from a niche investment to ever-greater popularity. According to Jefferies, their share of the overall secondaries market has almost doubled from 24% in 2017 to 46% in 2023, and their volume in the growing market as a whole has almost quadrupled from USD 14 billion to USD 52 billion.[1] The trend is continuing to rise: Jefferies estimates a GP-led volume of USD 65 billion for 2024, which would again correspond to a share of almost 50%.

The international investment service, William Blair, also observes that more than half of GP-led transactions this year are likely to be single-asset continuation funds, i.e. continuation funds that are set up specifically for a single asset[2]. There is a noticeable specialisation in this segment, which allows new investors not only to participate in potential private equity success stories with an existing and comprehensible track record, but, with the inclusion of special secondaries portfolio funds, in this way, to build up a diversified portfolio.

The existence of secondaries creates advantages for everyone

Both LP- and GP-led secondaries solve a number of problems and are therefore an advantage for all the market participants involved, be they potential new investors, existing investors willing to sell or the fund managers themselves - in detail:

Investors wishing to sell their fund units are given the opportunity to dispose of them at any time. The more liquid the secondary market, the more fungible trading in fund units becomes: Speed and flexibility increase, transaction costs fall and experience has shown that discounts often also fall in liquid markets. The market growth of LP-led secondaries consequently improves the opportunities and flexibility of investors. The reasons for selling can be varied and very individual. GP-led secondaries also give existing investors the opportunity to decide whether to realise a profit or remain in the asset.

- Potential new investors can gain access to investment opportunities that already have a track record. By eliminating this "blind pool risk", not only can the risks and potential returns be better assessed, but the composition of the overall portfolio can also be better controlled, for example by region or sector. Later entry in the maturity cycle of a private equity investment avoids or can at least reduce the effect of what is known as the "J-curve." The possibility of being able to exit at a freely selectable point in time that secondaries offer and in this way maintain an additional exit perspective should also favour the investment decision in most cases. This new "sub-asset class" also opens up a new area of business, namely the launch and distribution of special secondaries funds that give investors access to the many advantages of the secondary market.
- Fund managers gain significantly more flexibility. In addition to the three exit strategies of sale to a financial investor, sale to a strategic investor and IPO, fund managers also have a fourth attractive exit option, which offers existing investors a liquidity option, while the manager continues to manage the asset in a new vehicle and can participate in the investment success by way of performance-based management fees.

The current environment offers secondaries investors an interesting entry point for both LP-led and GP-led secondaries. In view of the changed market situation, in which interest rates are likely to remain significantly higher for a longer period than was the case two years ago, some institutional investors are reconsidering their previous portfolio allocation and are likely to divest one or two private equity investments. This, in turn, is currently leading to an inflow of attractive investment opportunities at still existing price discounts.

At the same time, the changed interest rate environment is making it more difficult for some private equity companies to raise debt capital. With a GP-led transaction, it is possible to mobilise additional equity capital for the company as an alternative. Ultimately, last but not least, following the private equity boom of the low-interest years, some funds and their assets are now reaching a maturity phase in which an exit was envisaged, but which may no longer be considered opportune by some investors in view of the changed market environment, while others would like to (or have to) release liquidity. These are typical cases for GP-led transactions, which we are consequently bound to see more frequently.

[1] Jefferies Global Secondary Market Review, January 2024
[2] Jefferies H1 2024 Global Secondary Market Review, July 2024
[3] William Blair PCA Quarterly News Bulletin, June 2024