Secondaries | The silent liquidity revolution on the secondary market for private equity

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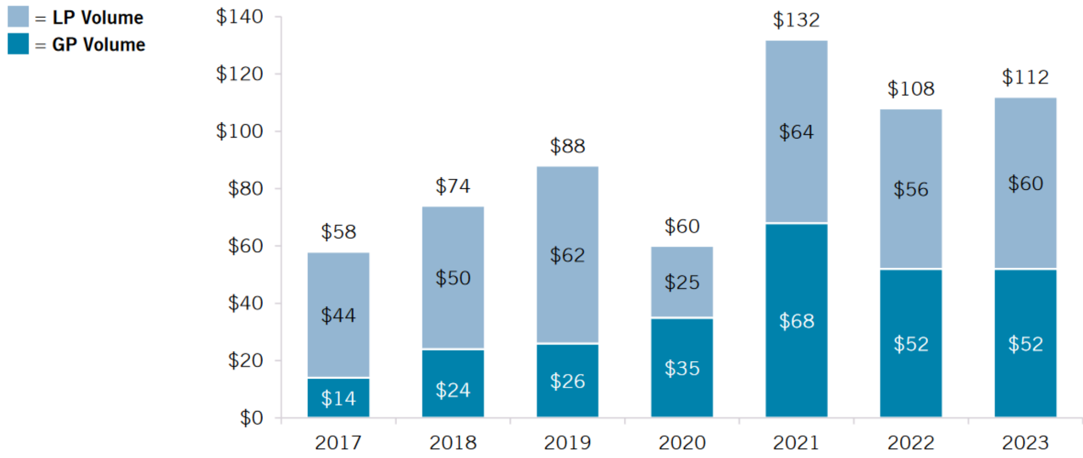
The range of alternative investments is impressive, but one investment opportunity stands out: secondaries reported a strong performance last year. A look at the latest market data shows clearly the impact of rising interest rates on the secondaries markets. And it also shows that a shift is taking place – and that the long-term success of secondaries continues unabated.

The volume of secondary transactions came to some US$ 112 billion in 2023, the second-highest figure in the history of this market. Secondaries continue to attract professional investors. There are various reasons for the increasing interest in secondary investments. After suffering as a result of the first wave of the covid-19 pandemic, secondaries reported a record year in 2021, driven by greater market liquidity and pent-up demand. They continued their growth trend in 2022 and 2023, when interest rates suddenly changed tack.

Fig. 1. Annual Transaction Volume ($B)



Source: Jefferies Global Secondary Market Review January 2024, p. 3

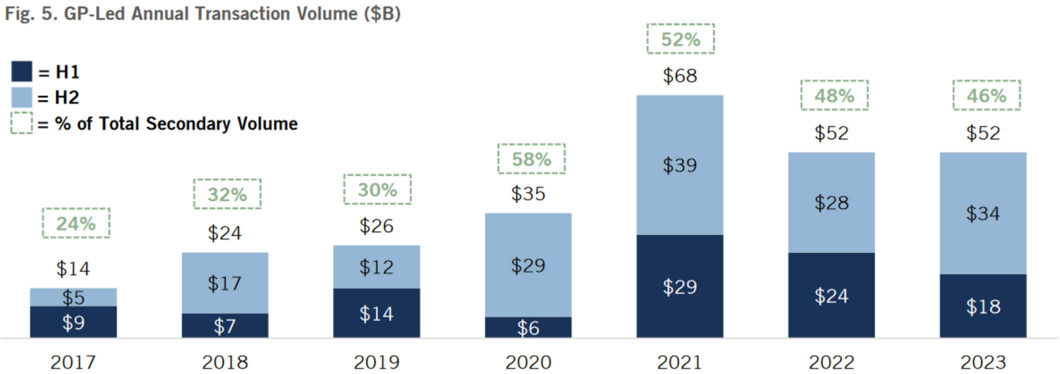
The growing importance of secondaries in the alternatives universe

If secondaries were once a practical expedient for getting out of a fund early, they have increasingly become a tool used by both LPs and GPs for efficient portfolio calibration and liquidity management. Private markets for physical assets are actually illiquid, but secondaries give them a new liquidity dimension.

An early departure from a fund by means of a secondary deal is generally initiated by the fund investor, or limited partner concerned and so is known as LP-led. It enables the seller to release liquidity or adjust their portfolio strategy at short notice and at an individual fund level. For many investors this made it an important instrument for reducing relative over-allocations to private equity caused by losses in liquid shares and fixed-income securities, especially when interest rates started to rise for the first time. As interest rates continued to go up, it was the lack of conventional private equity exits in a dwindling M&A market that favoured this kind of transaction. According to data from Jefferies, LP secondaries were priced at an average of 92 per cent of their book value in 2021. The about-turn in interest rates increased the pressure on LPs to sell and reduced average prices to 81 per cent of book value, before they stabilised again more recently at an average of 85 per cent.

Following the same logic of seeking liquidity as their investors, fund managers have also learned to make active use of the secondaries market. These GP-led secondaries enable fund managers with what are known as “continuation vehicles” to keep developing their most attractive portfolio companies beyond the original investment horizon, or for longer than originally planned, by raising additional growth capital for operating investments or add-on acquisitions. At the same time they satisfy their investors’ desire for liquidity, because it means they can realise profits. Investors have a choice: to stay invested in the company or take the liquidity. If they choose to stay invested, they continue to benefit from the risk-reduced performance of a practised team made up of the fund managers and the company management.

Fig. 5. GP-Led Annual Transaction Volume ($B)



Source: Jefferies Global Secondary Market Review January 2024, p. 7

Over the years, this has enabled GP-led secondaries to progress from a niche investment to ever-greater popularity. The volume of GP-led secondaries in the second half of 2023 gives an indication of the short-term potential of the market.

Conclusion

For specialised buyers of secondaries and their investors this is an interesting time to enter the market, in order to profit from the current situation in both sub-segments. Gaining direct access to established private equity portfolios makes it possible to avoid the J-curve effect, while achieving attractive private equity returns with reduced risk and good diversification at the same time. Since the price discounts are still out there, it is a window of opportunity for experienced investors. The former niche secondaries market has become established, and in the long term it will play an even bigger role in the portfolios of professional investors looking to invest in promising private equity companies or take advantage of the shorter liquidity profile.