The case for secondaries remains intact

Blog

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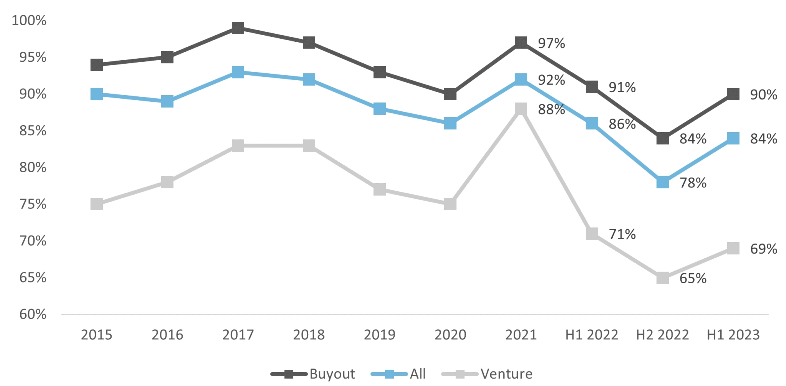
For some time now we have been recommending a focus on so-called secondary market investments in addition to conventional primary private equity vehicles. Unlike primaries, secondaries acquire more mature private equity positions, often at a discount, stemming from the liquidity needs of certain investors to adjust their private asset allocations. Economic stress typically enhances investment opportunity in secondaries. Last year's market decline saw public valuations drop and exit activity contract, leading to unusually large discounts in secondaries. More recently, these discounts have narrowed, but continue to present attractive entry points in our view.

Secondaries in 2023

Secondaries entered 2023 with meaningful discounts. According to Jefferies data, average limited-partner-led secondaries traded at more than a 20% discount to NAV at the end of 2022. Now, over halfway into the year, prices have bounced back, supported by improving public valuations and optimism about the economic outlook. Secondary volumes have also moderated as limited partners' (LP) immediate hurry to sell has lessened amid lower pressure from the denominator effect (value of public relative to private holdings) and improving price expectations. While recent dynamics may suggest a narrower opportunity set, we continue to see allocations to secondaries as attractive in the current environment.

Pricing as % of NAV



Source: Jefferies Global Secondary Market Review 1H2023, UBS as of August 2023

Both buyers and sellers are still incentivized to transact. While investors are less concerned about portfolio "overallocation" and distressed selling, many (especially pension funds) are seeking to generate liquidity events given slower distribution prospects. Others are considering secondary sales to improve manager quality or to allocate to more recent funds. Meanwhile, capital dedicated to the strategy has increased. Pitchbook fundraising data indicate that funds focused on secondaries have raised near USD 31bn in the first quarter, or two-thirds of the total funding obtained in 2022. With improving pricing dynamics, and motivated buyers and sellers, we expect bid-ask spreads to further narrow and transactional activity to pick up in the second half of 2023. Jefferies data, while indicating contracting volumes, also show a higher closing rate on recent transactions (58% in 1H23 compared to 44% in 2022), which bodes well for the second half of the year. Lastly, discounts remain unusually wide compared to history. At 16%, they still present very attractive entry points to investors.

We note that while the balance remains in favor of LP-led transactions for now, secondaries led by general partners (GP), another segment of the market, are starting to attract more attention. GP-led secondaries typically consist of a general partner transferring an asset or portfolio company (often a trophy asset) from one vehicle to another (e.g., continuation fund). Such transactions usually offer the option for existing investors to sell (or stay invested), while allowing fresh capital to invest and prolonging the holding period of the asset to maximize value. While representing more than 50% of the secondary market in 2020 and 2021, volumes have dropped to about 42% currently. Such transactions tend to offer limited discounts compared to LP-led deals. But recent deals have started to exhibit additional incentives including earnouts, deferrals, and preferred equity.

Secondaries beyond the tactical horizon

More broadly, secondary funds offer diversification benefits and defensive characteristics that we believe are valuable when building private asset portfolios. As managers buy mature fund stakes, they can analyze underlying investments more precisely before making an investment decision, thus reducing so-called blind pool risk. Acquired assets are typically highly diversified across geographies, strategies, and vintage years which typically help to reduce the variability of returns. Lastly, because they target more mature fund stakes and assets, secondary managers deploy capital quicker than a typical primary fund and thereby provide an accelerated exposure to private assets. Investors also receive a return of their capital earlier than that of a typical primary fund investor. This enables investors in the process of building a private equity portfolio to mitigate the so-called J-curve effect.

For both investors new to the private equity asset class and more experienced ones with more concentrated portfolios, we think adding secondary exposure makes sense in the current environment, as a source of diversification and with a lower return volatility than primary buyout funds. Choosing the right manager is of key importance to success, however, to ensure participation in quality deals and potential access to high-performing assets. Investors should also consider that while secondaries may be more diversified, they remain subject to risks inherent to private markets. These type of investments require longer lock up periods, can include higher fees and limited control, and should fit an investor's personal and financial goals along with liquidity constraints.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

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