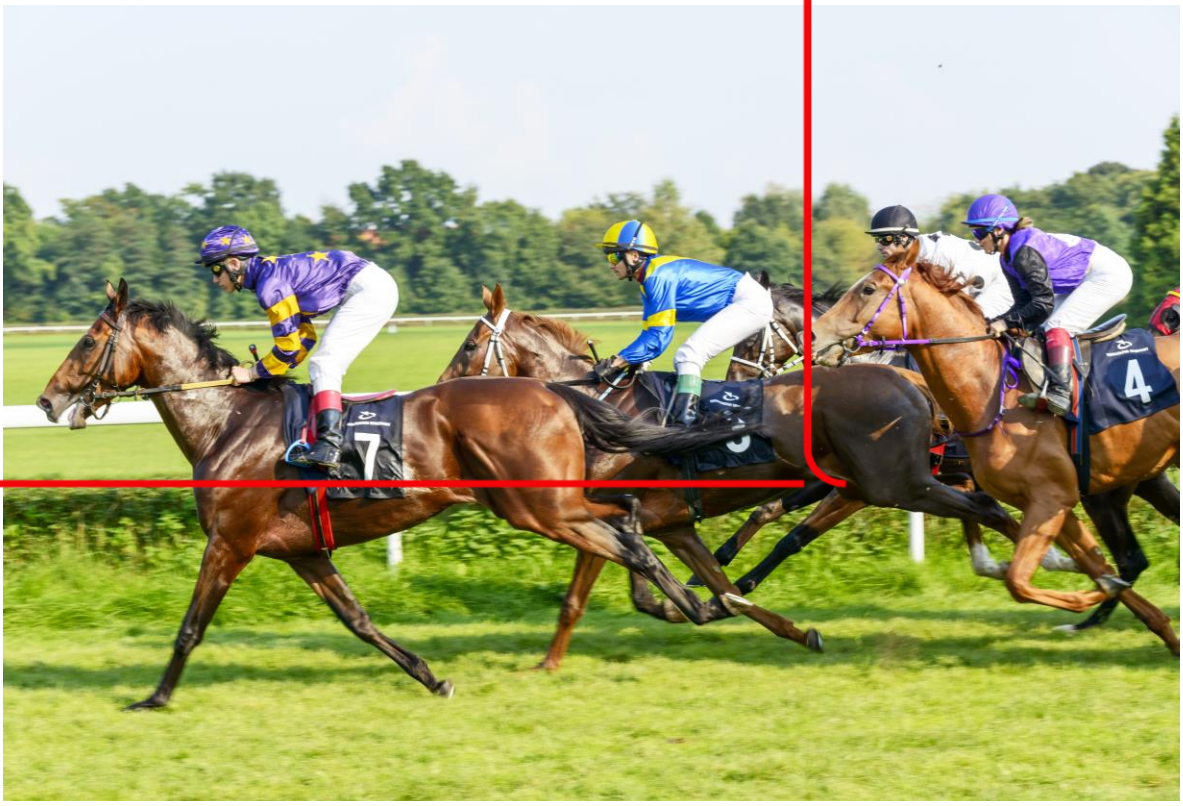
UBS Asset Management

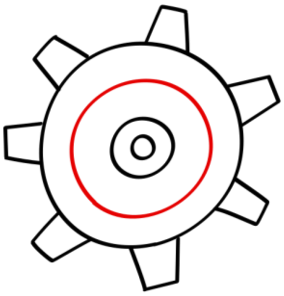
Getting ahead

Private equity secondaries investing



The enduring appeal of private equity

Private equity is an important source of capital for startups, young companies, firms in financial distress and companies that are seeking growth or buyout capital. As opposed to many other investment styles, private equity is an inherently *activist* asset class whereby the fund managers often exert significant influence over the underlying investments. Thus, investors in the asset class not only benefit from gaining exposure to otherwise inaccessible, *unquoted/privately owned* companies, but also from the skill-sets that fund managers bring to bear to improve a company's long-term value.



The need for private equity secondaries

Private equity funds pool capital from investors into strategy specific funds, e.g. funds that focus on buyouts in specific geographies or industries. These funds are typically organized as closed-end funds with limited liability for investors (also commonly referred to as Limited Partners or LPs). These closed-end funds are managed by General Partners (GP) who make all decisions on behalf of LPs, such as completing or exiting an investment. These closed-end funds typically have a life-span (or term) of 10 or more years and do not have a built-in exit or liquidity mechanism for investors.

Closed-end funds also operate a *commitment model*, meaning that capital is called from investors over time as opposed to being paid-in at the time an investment decision is made. This often happens with very short notice periods (10 business days is fairly standard). While this setup enables GPs to take a long-term view to investing and driving value creation in the underlying companies, there are certain drawbacks. Most significantly, the lack of a built-in liquidity mechanism means that LPs who wish to, or have to exit a fund prematurely have no choice but to sell their interest on the private equity secondaries market.

In a typical secondary deal, a purchaser will acquire private equity assets from a seller in a privately negotiated transaction and assume the seller's rights and responsibilities. In order to ensure that only suitable investors replace departing investors, the GPs of the private equity funds usually have to consent to a transfer and a release of the selling LP from their obligations. We refer to these transaction types as LP-centric transactions, i.e. deals that are driven by, or for the benefit of, an LP.

However, the restrictions of the closed-end fund model can also affect GPs' ability to manage investment portfolios and drive value creation initiatives: the finite terms of closed-end funds often mean that companies are being sold although further value could be created with more time. Also, given the fixed fund sizes of closed-end funds, there are limits as to the amount of follow-on capital that can be allocated per company to maintain appropriate diversification within a portfolio. In recent years, more and more GPs have discovered that the secondary market can provide them with the necessary time and capital to circumvent those limitations via GP-centric transactions.

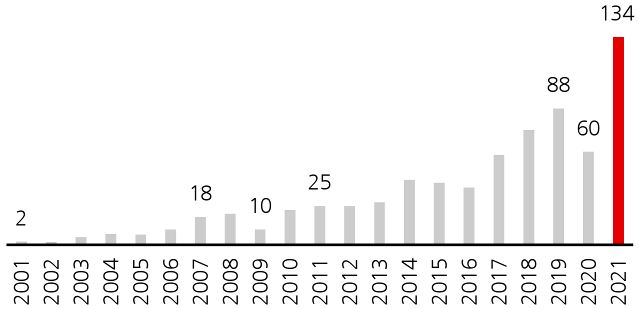
Secondary market evolution on a page

Private equity secondaries as a sub-asset class has evolved from a relatively small, somewhat obscure niche in the early 2000s into a fully accepted, integrated part of the overall private equity ecosystem. While aggregate transaction volumes in the early 2000s were barely USD 2 billion and had just touched on USD 18 billion before the Financial Crisis hit in 2008 (see Figure 1), volumes have now skyrocketed to over USD 130 billion in 2021.

In fact, in 2021, it is estimated that just over 50% of transaction volume – about USD 68 billion – was driven by GPs who were looking for more time, capital or both to work with specific assets, up from 18% or merely about USD 7 billion in 2015.

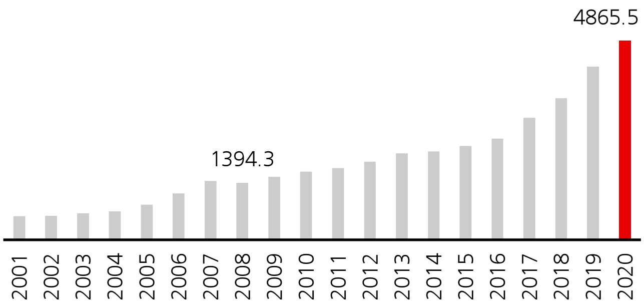
Increasing allocations to private equity
Assets under management (AuM) have grown enormously over the last decade (see Figure 2), providing a *target rich* environment for buyers. Preqin estimates that private equity AuM reached USD 4.9 trillion at the end of 2020 and will exceed USD 11 trillion in 2026, providing a huge source for secondary investments.

Figure 1: Secondary transaction volumes
(USD billion)



Source: Greenhill, Global Secondary Market Review, January 2022

Figure 2: Private equity assets under management
(USD billion)



Source: 2022 Preqin Global Private Equity Report

This enormous growth in volumes has been driven by a confluence of factors:

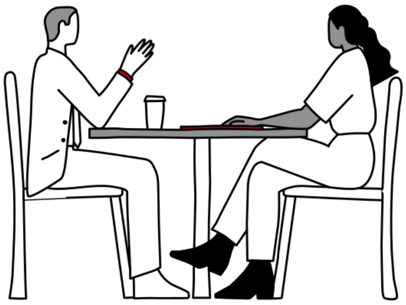
Attitudes
Sentiment towards secondaries across LPs and GPs have changed dramatically: while selling a fund was initially perceived as indicative of a problem, that perception has completely changed over the last decade or so. Secondaries are now a fully accepted, established portfolio management tool and has been embraced by the entire private equity investing ecosystem.

Transaction types and structures
While secondaries were initially almost exclusively the domain of LPs, GPs in the last decade have enthusiastically embraced the secondary market as an additional tool to actively manage their portfolios, firms, and investor base.

Professionalization
The level of intermediation of the market has increased, process standards and transparency have improved and transaction costs have come down significantly. There are now dozens of professional brokers active in the market that can serve as a trusted third party and provide advice and insight on pricing, market standards and transaction structures. This is improving transaction certainty for buyers and sellers alike.

Capital inflows
Lastly, and perhaps most importantly, returns for secondary funds have historically been quite attractive and led to an increased interest in the space from investors. Jefferies, an intermediary, estimate that available dedicated secondary dry powder for 2022 stands at ca. USD 84 billion and that more than USD 100 billion will be raised in 2022[1].

[1] Jefferies, Global Secondary Market Review, January 2022



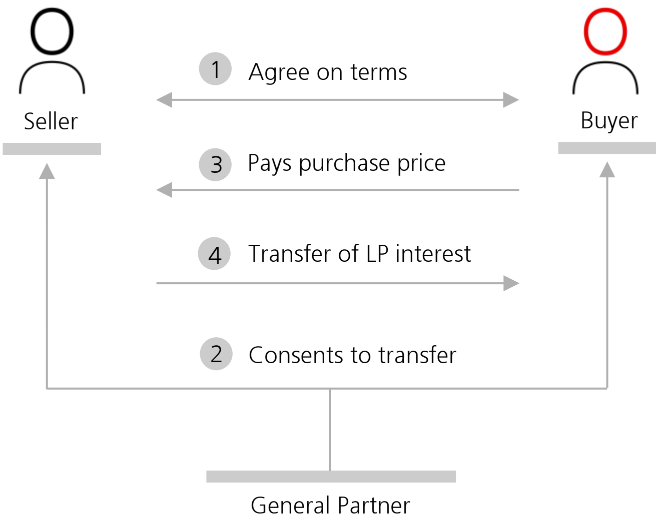
The mechanics of LP-centric transactions…

In a typical LP-centric transaction (see Figure 3), a buyer and a seller agree on a set of assets that are for sale and at the start of the transaction agree on a valuation date (sometimes also called the reference date). This is typically the date when the most recent financial statements for a fund have been published (usually at the end of a quarter).

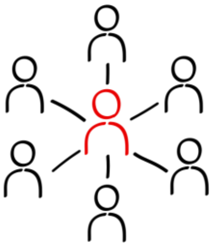
Any pricing is set relative to the valuation date, and expressed as a percentage of the reported value. Any cash flows that occur between the fund and the seller after the reference date are being taken into account in the final cash purchase price calculation. Capital calls that the seller has paid for increase the cash purchase price to ensure the seller gets reimbursed. Distributions are then subtracted to make sure the buyer does not pay for something they never received.

Importantly, any valuation changes between the reference date and the date the transaction closes accrue to the buyer – for better or worse. In each transaction, the GP of the fund usually has to approve a transfer in order to make sure that the new buyer is a suitable replacement for the seller. Some GPs are very selective in their transfer policy. Therefore, it is advisable, in our view, to inform a GP upfront of the intention to sell an interest to avoid potential pitfalls later in the process.

Figure 3: Typical steps and participants in a LP-centric transaction



Source: UBS Asset Management, Real Estate & Private Markets (REPM), February 2022



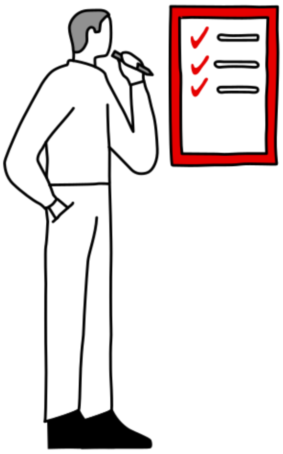
…and GP-centric transactions

In a typical GP-centric transaction, a GP would have identified a specific subset of assets they already own in older funds, which would benefit from additional time and/or capital and articulate a new value creation plan for potential acquirers. A consortium of secondary buyers would come together and rally around one (or several, depending on transaction size) lead buyer who sets the terms of the transaction, such as pricing for the assets to be acquired, new economics for the GP, amount (if any) of follow-on capital and new terms for the new entity, to name just a few.

Once the final terms have been agreed, the GP inform the LPs of the selling funds and usually provide them with the choice to either participate in the new transaction or simply receive the proceeds from such a deal.

Given the diversity and complexity of these transactions, understanding the alignment of interests of all participating parties – particularly the GP, but also the management teams of the respective companies involved – is key.

Where investors are getting the most value



It takes around three to five years for a private equity asset to find its way onto the secondary market, unless extraordinary circumstances require an LP or GP to change course early on. This benefits secondary investors in various ways:

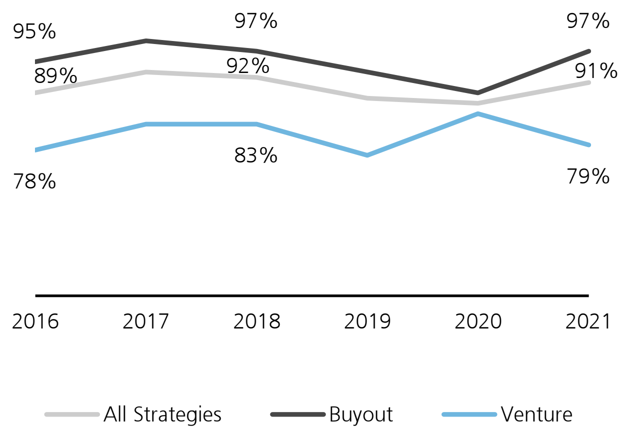
Quick ramp-up of exposure
When compared to traditional private equity multi-manager investment solutions, secondary investment strategies can generate full exposure to the asset class three to five years faster.

Given that secondary buyers acquire partially funded and invested positions, there is reduced blind-pool risk compared to traditional private equity multi-manager investment solutions. Secondary buyers can identify value drivers and underperformers as part of their underwriting process and adjust their headline pricing accordingly.

Generating liquidity, but faster
As assets are being acquired at a later stage in their lives, remaining holding periods are typically shortened, in particular in cases where funds or portfolios of funds are being bought from other LPs. Secondary-focused strategies, particularly those that include these traditional transaction types, are thus generating liquidity much quicker than other, traditional multi-manager investment solutions.

Purchasing at a discount, riding the J-curve
In secondary transactions that entail the acquisition of single funds or fund portfolios, secondary buyers often have the ability to buy positions at discounts to the reported net asset values leading to initial book gains at closing due to the transaction mechanics (see Figure 4). These initial book gains help offset the so-called *J-curve effect*, a period of initial negative performance that is inherent in private equity.

Figure 4: Historical secondary pricing (as % of NAV)

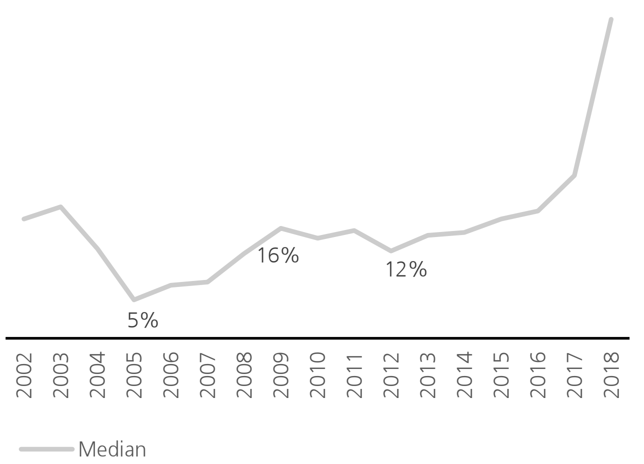


Source: Greenhill, Global Secondary Market Review, January 2022

Return metrics

Historical return profiles for 216 secondary funds collected by Cambridge Associates, a consultant, exhibit some interesting characteristics for secondaries as an asset class: Figure 5 plots internal rates of return (IRR) by quartile for secondary funds of various vintage years. For funds delivering Median performance, the longer-term record shows that IRRs are consistently in the mid-double digits. The sky-high IRRs of more recent vintage years on the right side are driven by initial gains as managers take advantage of acquiring assets at discounts to reported net asset values, an effect that trails off over time.

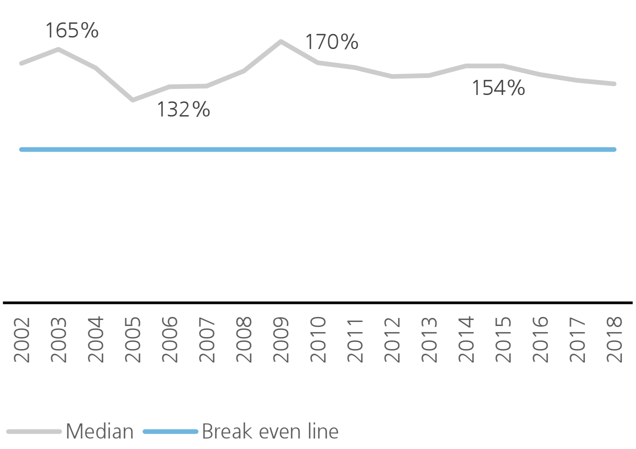
Figure 5: Median IRR for private equity secondary funds per vintage year



Source: Cambridge Associates data extracted on 20 July 2021, performance metrics as per 31 December 2020. Data is continuously updated and subject to change. N = 216. Past performance is not a guarantee for future results.

Also, note that IRRs are positive in all vintage years, for all fund quartiles, a phenomenon even better illustrated in Figure 6 which plots the ratio of *total value* generated by secondary funds to *paid-in* (TVPI) capital for the various vintage years. The chart shows that median fund performance across all vintage years has been positive: even a *bad* vintage year (2005) still delivered investors a gain of 32 cents for every dollar paid-in - in the median case. What is furthermore notable is that performance for the 2003 and 2009 vintage years is better than other vintage years, a function of the inherently countercyclical nature of secondary investing as sellers generally tend to accept steeper discounts in times of distress.

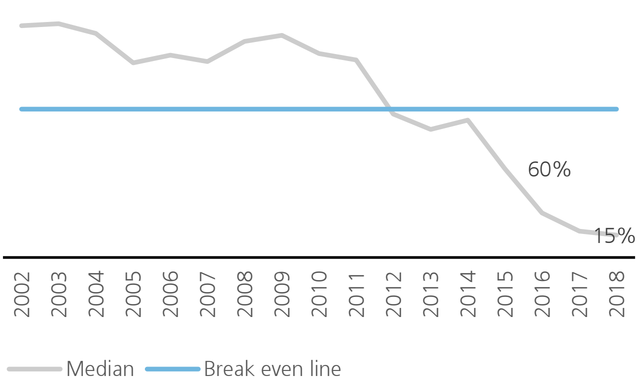
Figure 6: Median total value to paid-in ratios for private equity secondary funds by vintage year



Source: Cambridge Associates data extracted on 20 July 2021, performance metrics as per 31 December 2020. Data is continuously updated and subject to change. N = 216. Past performance is not a guarantee for future results.

Lastly, Figure 7 illustrates *distributed-to-paid-in* (DPI) ratios for the various vintage years. What is notable here is how quickly secondary funds generate liquidity for investors. Keep in mind that the data presented is as of end of December 2020. This means that a 2018 vintage year fund at that point is at most two years old and – in the median case – already has distributed 15% of the paid-in capital back to investors.

Figure 7: Median distributed-to-paid-in ratio for private equity secondary funds by vintage year



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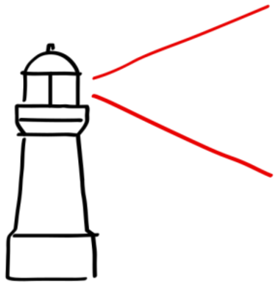

A word of caution on returns

Comparing private equity return profiles to each other and with public markets is notoriously difficult and full of pitfalls: for starters, the available data sets for private equity are all limited in length and breadth (please note that this point in particular applies to the figures presented above – 216 funds over a period of 16 years is not a lot!). *Survivorship bias* in the data is a constant risk lurking in the background (ditto for this dataset).

Adjusting for different leverage ratios between public markets and private equity portfolios is highly complex, especially considering that many private equity funds themselves are employing leverage on the level of the fund to optimize cash flows between the funds and investors. This is in addition to the leverage employed in the underlying portfolio companies.

Also, many secondary buyers – particularly in the large and mega segment of the market – employ capital call lines or deal level leverage (or both!) to maximize returns and manage cash flows between the funds and investors.

Investment strategies and approaches evolve over time. For example, within the secondaries space, GP-centric transactions were not as significant for the market in 2012 as they were in 2021. The performance of a secondary buyer that focused only on GP-centric transactions in the last three years would look significantly different from his peers that only focused on acquiring fund books at discounts.

Lastly, the practice of acquiring assets at a discount and then marking them to reported net asset value at closing means that IRRs for secondary funds initially can be very high and then trail downward over time. Finally, IRR alone is an imperfect performance metric ("Can't eat IRR"): we believe that in addition, an investor needs to at least look at TVPI and DPI ratios.

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