MOONFARE

Private Equity Secondaries: Diversification at a Discount

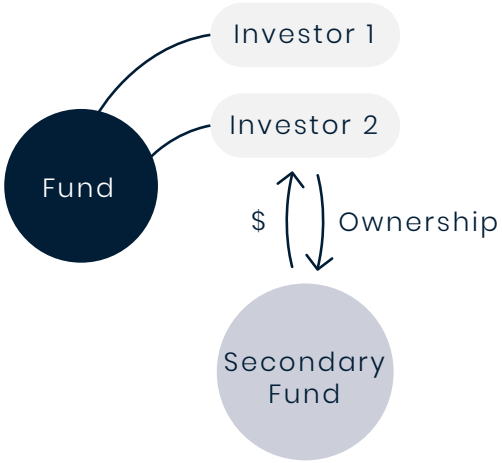
The importance of an alternative private equity asset class

THE SECONDARIES MARKET

In the late 1970s, regulatory changes permitting US pension funds to invest in private equity transformed the asset class and drastically increased the number and volume of private fundraisings. By the mid-1990s, private equity had already started maturing and institutional investors allocated as much as 15% of their portfolios to private equity. The implementation of new regulation around this time, however, introduced requirements for commercial banks and insurance companies to hold higher capital reserves to support their alternative asset investments. These requirements fuelled the need for a secondary market, as institutions moved to reduce their exposure. As a result, the first secondary focused funds were launched towards the back end of the decade.

But what is distinct about the nature of the transactions underlying these secondary funds? A secondary transaction is an "over the counter" transaction, which in its simplest form, entails one investor buying the current ownership rights and assuming any remaining commitments from the existing investor. Even though secondary transactions can be structured in a number of ways, adapting to the uniqueness and complexity of each situation, we can classify secondary transactions in three main categories:

1. LP Secondary Transactions
2. GP Restructurings
3. Direct Secondary Transactions

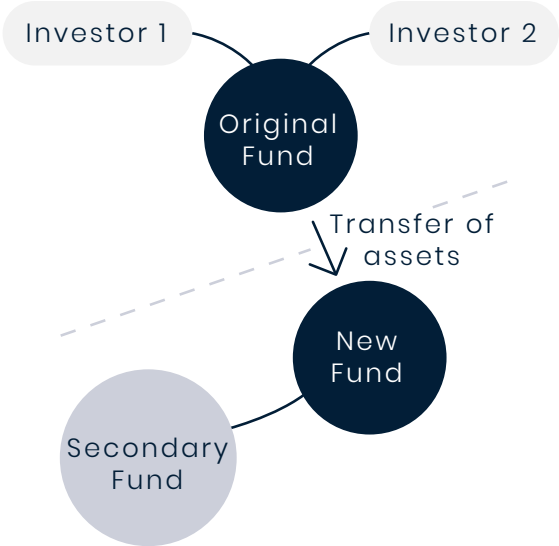


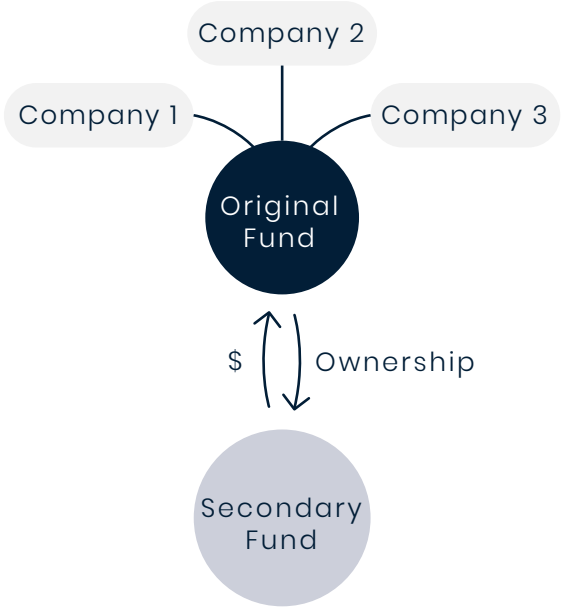
LP SECONDARY TRANSACTIONS

This is the most common secondary transaction, representing 68% of transactions in 2018[1]. In such cases, an existing LP sells to a secondary buyer its fund interest(s) in private market funds. The buyer replaces the LP in any fund in which interests are acquired.

GP RESTRUCTURINGS

In GP Restructurings, the portfolio companies are transfered to a new fund vehicle. Existing LPs have the option to either roll over or sell the interest to a secondary buyer. In order to refocus the GP's efforts on the portfolio and align its interests with the secondary buyer, new terms are implemented on the acquired stake.





DIRECT SECONDARY TRANSACTIONS

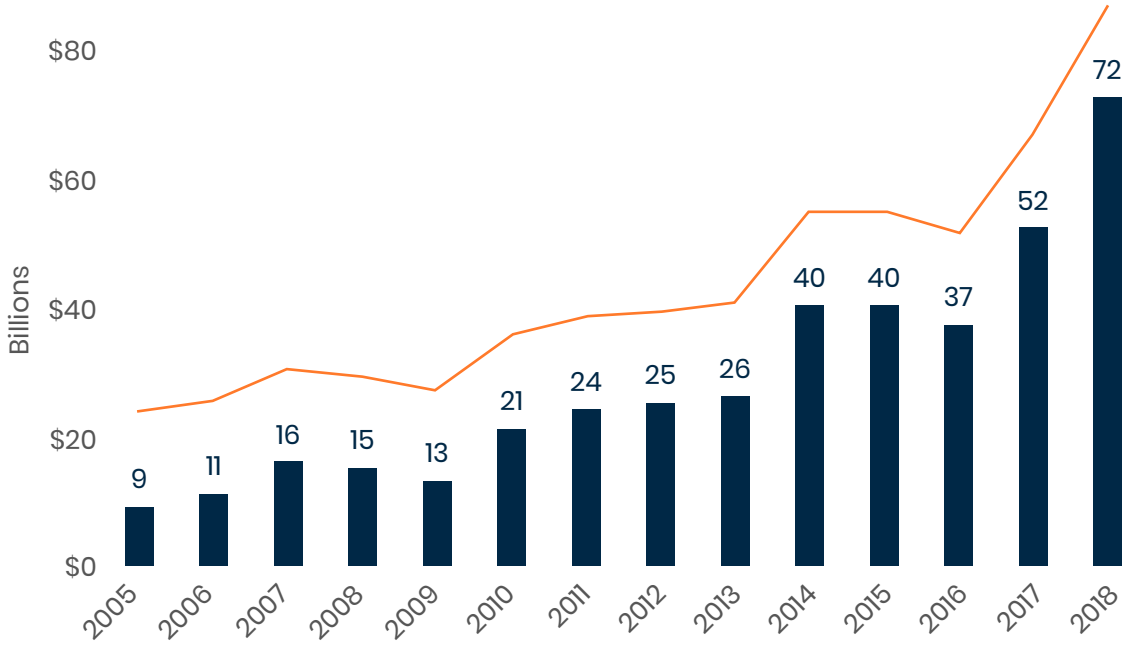
A direct secondary transaction occurs when an investor sells a portfolio of companies to a secondary buyer. Often, the secondary buyer will hire a GP to manage the portfolio.

THE EVOLUTION OF SECONDARIES

According to Bain Capital's 2019 *Global Private Equity Report*, PE fundraising has exceeded $2.25tn in the last three years. Along with a strong flow of primary commitments, secondary funds have followed suit. As a result, secondary transactions exceeded $70bn in 2018[1].

The growth in secondary transactions has been supported by an expanding base of primary commitments as well as by the need for active portfolio management on the part of LPs.

Figure 1: Secondary Transaction Volume 2005-2018



Source: Coller Capital.

Especially since the 2008 financial crisis, the regulatory environment has turned more stringent, often forcing financial institutions to scale back their private investment holdings.

In general, there are three main reasons for exploring liquidity options in the secondary market.

1. Regulatory changes and heightened regulatory scrutiny

Especially since the 2008 financial crisis, the regulatory environment has turned more stringent, with regulations like the Volcker Rule, Basel III, and Solvency II often forcing financial institutions to scale back their private investment holdings. More specifically, stricter minimum capital requirements have increased the balance sheet reserves needed for holding private equity funds.

2. Changes in asset allocations and investment strategy

Certain institutional investors value the potential to actively manage their portfolio allocations. The reasons for such rebalancings include, for example, investment strategy shifts, a desire to benefit from market anomalies, and a need to return to target allocation levels after market dislocations. These actions can be especially pronounced in periods of heightened volatility.

3. Portfolio management

Given the diversity of institutional investors in private markets, there are various idiosyncratic reasons for seeking out liquidity in the secondary market. For example, having a large number of sponsor relationships might require substantial resources for due diligence, relationship management, and portfolio monitoring. Such an investor might want to find a way to sell interests in non-core sponsors, thereby reducing the requirements for in-house analytic capacity.

WHY INVEST IN SECONDARIES?

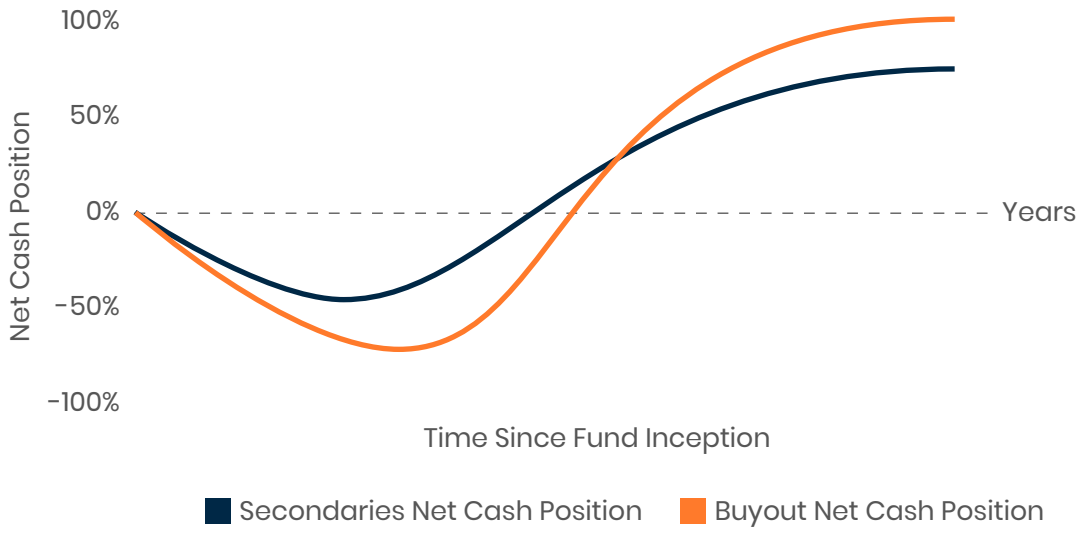
The price LPs pay in exchange for secondary buyers purchasing their fund interests and providing liquidity is, in most situations, a discount to the net asset value (NAV) of their existing interests. The discount levels can vary depending on the relevant idiosyncratic risks of the fund interests and on the macro environment, since in recessionary markets liquidity premiums have tended to increase. Indicatively, academic research estimates that the average discount at which secondary interests are transacted is approximately 14% of NAV[2], while during the 2008 recession, fund interests could be sold for as low as 50% of NAV.

Acquiring fund interests in secondary markets exhibits certain characteristics that buyers aim to take advantage of. These include:

1. Faster Return of Capital

Due to the relative maturity and NAV discount of the fund interests, secondaries offer the potential to mitigate the primary funds' J-curve effect. As shown in Figure 2 below, primary funds' initial capital calls during the investment phase generally draws on a net basis approximately 80% of investors' committed capital.

Figure 2: Indicative Cash Position J Curve



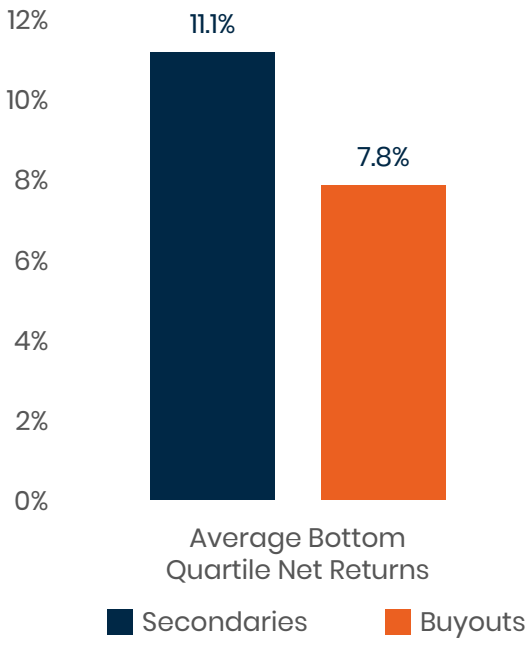
Source: Moonfare analysis.

Secondary buyers purchase fund interests that are already more and this enables them to offer investors a faster return of capital. This means that there will likely be a shorter holding period and earlier distributions. As a result, for secondary funds, the investor's negative cash position normally bottoms out at circa 50-60% of commitments[3]. Moreover, secondary funds, on average, distribute 1.0x of paid in capital back to investors within seven years which is about a year faster than primary private equity investments[4].

2. Attractive Diversification of Fund Interests

Secondary funds generally purchase a large number of interests, leading to a highly diversified portfolio. In fact, secondary funds often offer exposure to a larger number of fund interests than the typical fund of funds while they also enable diversification across vintages. One of the largest secondary investors invested in over 500 fund interests from over 200 fund managers in their latest secondary fund. This level of diversification creates a portfolio of diverse strategies, vintages, and geographies. This cannot be easily replicated in fund of funds that typically invest in 15-20 primary funds. But is this diversification of purchased primary fund interests accretive to the end investor?

Figure 3: Better Bottom Quartile Outcomes[5]



Source: Moonfare analysis based on data accessed via Pitchbook.

3. Unique Risk-Return Profile

Secondary funds decrease the tail-end risk that a private equity fund investor loses capital. From 2001 to 2015, the percentage of funds that were realized or marked at under 1.0x of invested capital was less than 5%, comparing favorably to the analogous buyout fund percentage of 11%[6].

Secondary funds have exhibited a better downside and tail-end risk profile

The bottom quartile net returns of the average vintage also reveals a better downside outcome for secondaries. At 11% net IRR, these returns for the asset class are more than 300 bps higher than that of the equivalent private equity buyout fund figure.

Apart from showing this higher downside resistance compared to buyout funds, secondaries show a unique risk-adjusted historical performance. Plotting the major private market fund segments on a matrix showing the standard deviation of IRR as well as the cumulative median fund net IRR figure reveals the risk-adjusted benefits of investing in secondaries (see Figure 4 on the next page).

Secondary funds have an average standard deviation of IRR that is similar to private debt funds but a median net IRR that resembles buyouts. Thus secondaries are closer to the top left corner which is the ideal direction for asset classes when plotted on a risk-return matrix.

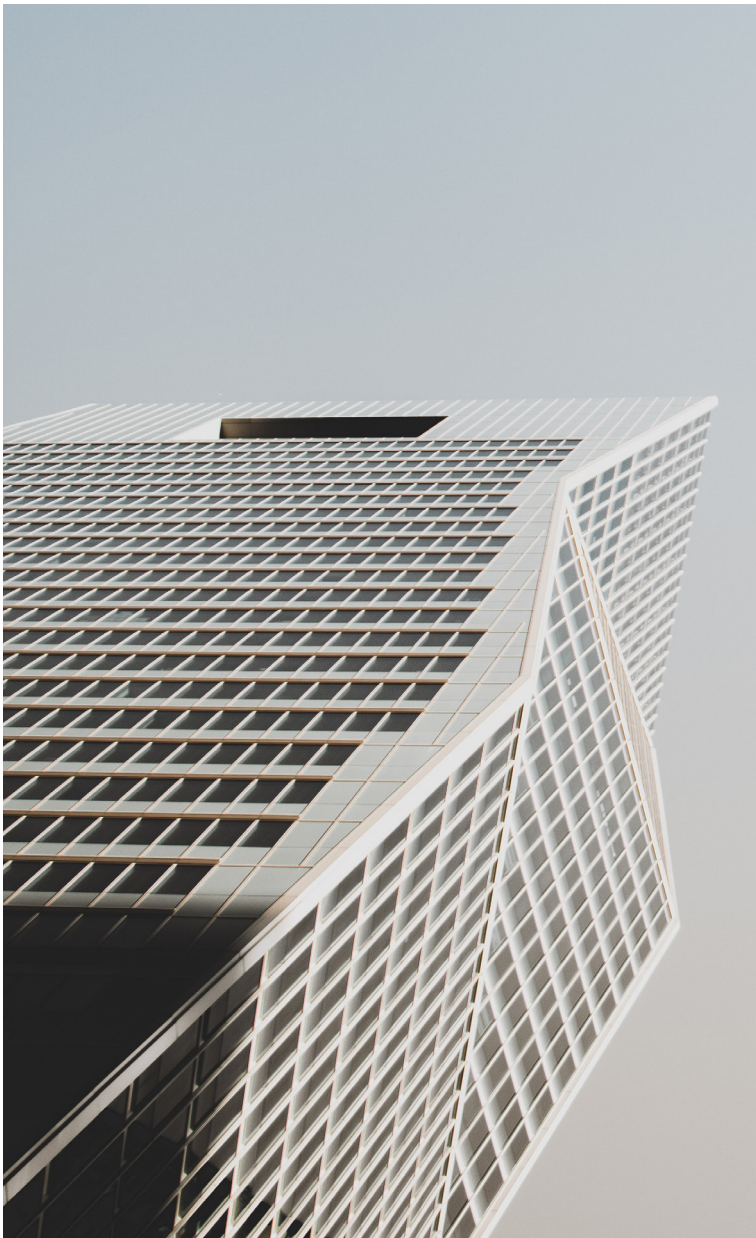
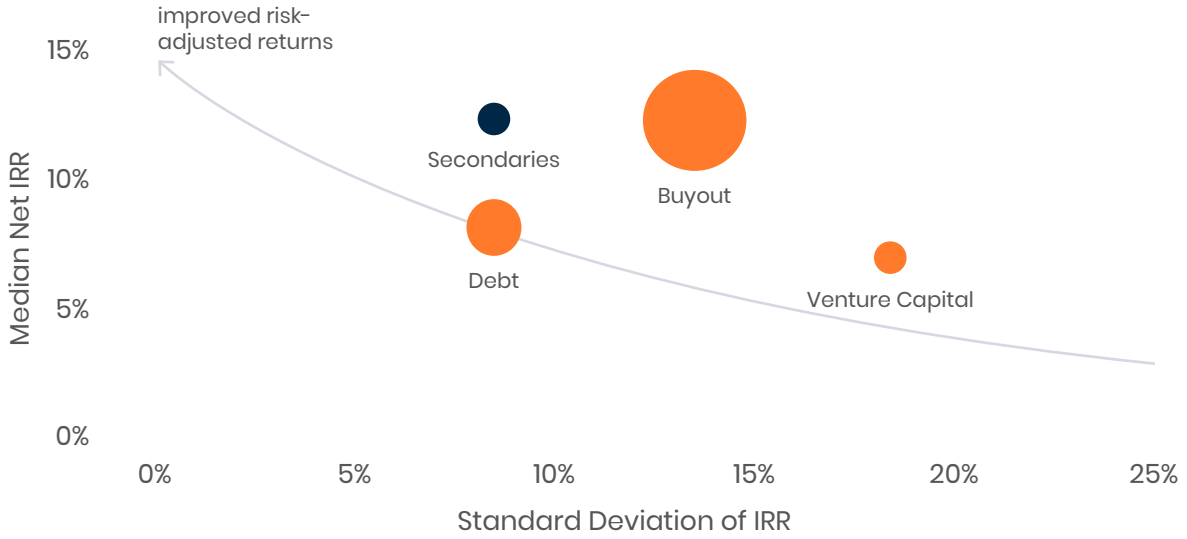


Figure 4: Private Markets Risk-Return Matrix[7]



Source: Moonfare analysis based on data accessed via Pitchbook.

SHOULD SECONDARIES COME FIRST?

There is a positive momentum supporting the investment thesis for secondary funds. First, there are structural reasons to expect this segment of the market to keep growing and deliver attractive investment opportunities as primary fund contributions keep increasing and international regulation continues to require active management on the part of large institutional investors. Second, as per Cambridge Associates' whitepaper on *When Secondaries Should Come First*, one can view secondaries as a reasonable first allocation to private markets.

In summary, secondary funds offer faster return of capital, wide diversification, and a notable downturn protection that might fit those that want to invest in a counter-cyclical way today.

FOOTNOTES

1 Coller Capital, 2019.

2 Nadauld, Taylor et al. 2017

3 Cambridge Associates, 2017.

4 Cambridge Associates, 2017.

5 Quartile results are from Pitchbook's Q3 2018 Benchmarks posted in Q2 2019. Vintage years included are from 2001-2015.

6 Data from Pitchbook database.

Loss ratio figures are calculated from Pitchbook database, accessed August 2019. Criteria:

i) Vintage 2001-2015

ii) Fund Size over $250m

iii) Fund type: "Secondaries", "Buyout"

7 Data from Pitchbook.

Median Net IRR figures are calculated from Pitchbook database, accessed August 2019. Criteria:

i) Vintage 2001-2015

ii) Fund Size over $250m

iii) Fund type: "Secondaries", "Buyout", "Private Debt", "Venture Capital"

Standard deviation of IRR figures are from Pitchbook's Q3 2018 Benchmarks posted in Q2 2019. Vintage years included are from 2001-2015. Standard deviation of IRR for any given vintage involves calculating the standard deviation of same vintage funds of the same type. We plot the average figure across vintages.

Bubble sizes are scaled according to the fundraising amount of the ten-year period ending in 2015, as reported by Pitchbook.

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1. Coller Capital, 2019. The Private Equity Secondary Market.

2. Bain & Company, 2019. Global Private Equity Report 2019.

3. Cambridge Associates, 2017. When Secondaries Should Come First.

4. Nadauld, Taylor D., Sensoy, Berk A., Vorkink, Keith et al, 2017. The Liquidity Cost of Private Equity Investments: Evidence from Secondary Market Transactions.

5. Pitchbook Q3 2018 Benchmarks, published Q2 2019 & Pitchbook data as of August 2019.

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