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No longer of secondary concern

Analysis of the global secondary market

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Credits & Contact

Analysts
JAMES GELFER Senior Analyst
CAMERON STANFILL Analyst

Contact PitchBook
pitchbook.com

RESEARCH
reports@pitchbook.com

EDITORIAL
editorial@pitchbook.com

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Key Takeaways

» 2017 has already set a record for secondary fundraising with over $34 billion raised across 18 funds. The average fund size has exploded to $1.8 billion as a few players dominate the space and have continued to consolidate.

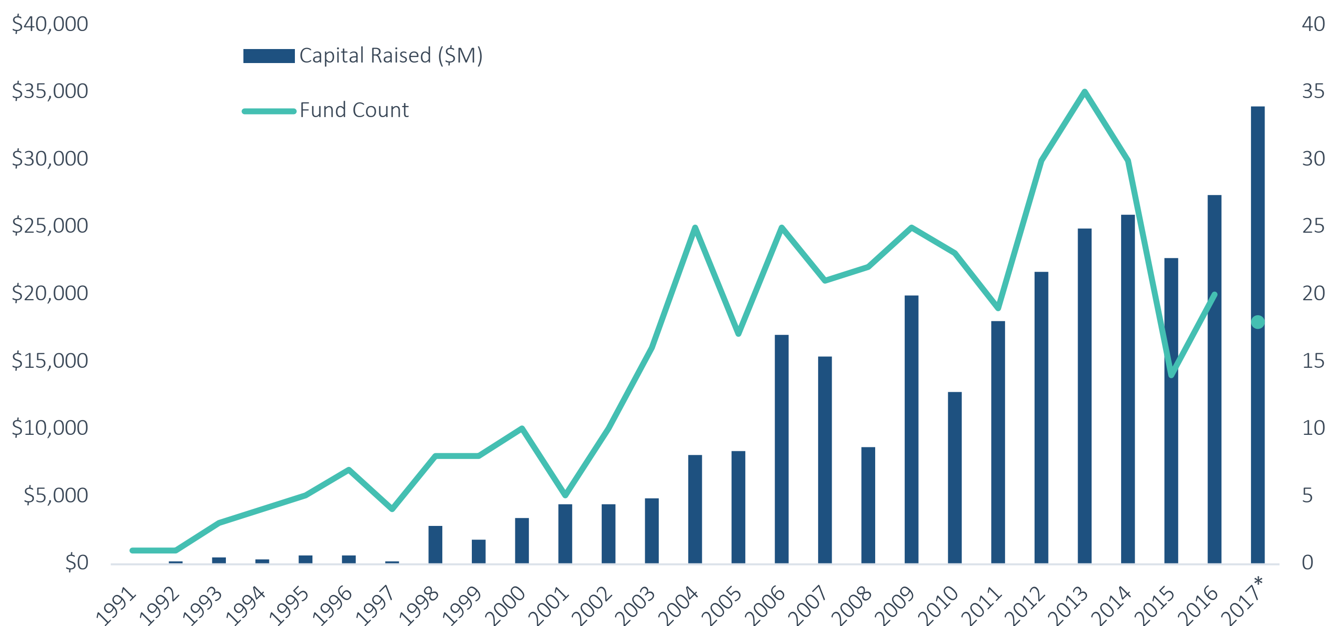
» Despite consistent growth in recent years and a buildup of dry powder, the secondary market has significant room for continued expansion, especially as managers raise more niche secondary funds.

» The purported J-curve mitigation provided by secondary funds bears itself out in the data; the average secondary fund has achieved a DPI of nearly 0.6x by its fifth year, compared to roughly 0.4x for buyout funds and 0.2x for funds-of-funds (FoFs).

Please note that this the scope of this Analyst Note pertains only to the LP secondary market. For more information on direct secondaries, please see: http://files.pitchbook.com/website/files/pdf/PitchBook_3Q_2017_Venture_Analyst_Note_Direct_Secondary_Markets.pdf

Three quarters into the year, 2017 has already set an annual record for global secondary fundraising with over $34 billion raised across 18 funds. Since 2000, secondary fundraising has methodically moved up and to the right at an impressive 13% compound annual growth rate. The secondary market has grown into a significant component of the private capital landscape, providing liquidity and portfolio management tools to both sellers and buyers of fund interests. So how did the secondary market get to where it is today?

Global LP secondary fundraising



Source: PitchBook
*As of 10/10/2017

History

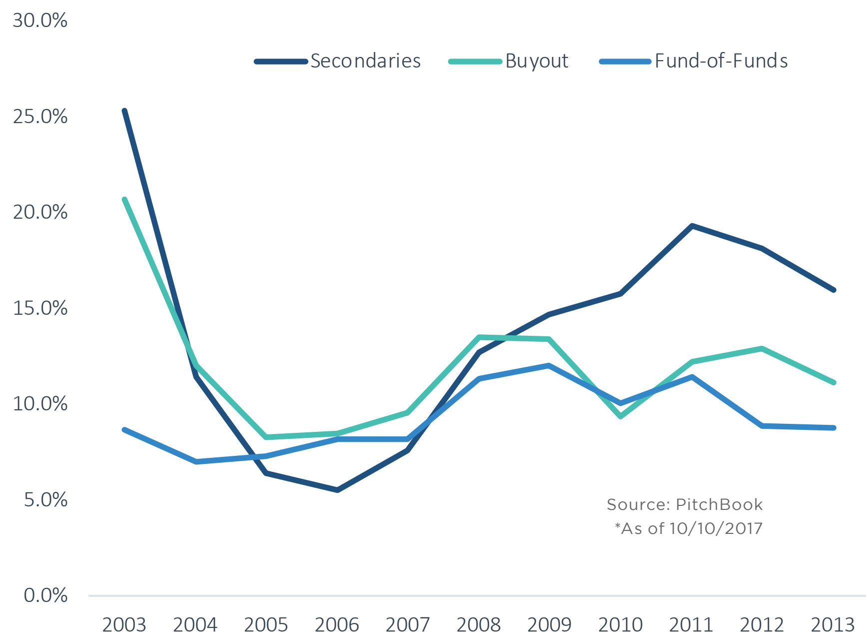
Secondary funds have been around since at least the 1980s but the strategy developed slowly, with fewer than 10 funds raised each year until 1999. A shift began to occur in the early 2000s, as secondary fundraising activity accelerated in parallel with the growth of the overall private capital industry, topping $10 billion for the first time in 2006. Secondary funds raised during this period delivered poor returns, which is perhaps unsurprising, given that performance during that period dipped for many primary strategies. Another explanation

for the challenging performance of mid-2000 vintage funds is that new, inexperienced managers were entering the space to capitalize on positive investor sentiment.

While the illiquid nature of private markets was never a secret, it wasn't until the depths of the financial crisis that a critical mass of limited partners simultaneously needed to reduce their private capital exposure. The reasons behind this were twofold. First, institutional investors' effective private equity allocations ballooned during the crisis due to the denominator effect, whereby decreasing valuations for public market holdings led portfolios to be disproportionally skewed towards the illiquid private markets. As a result, investors felt pressure to reduce their private equity holdings to comply with stated goals or mandates. Second, LPs such as insurance companies and corporate pensions were still required to meet their short-term obligations, which led to forced selling of various fund positions.

During this distress, secondary funds stepped in to fill the void, buying positions at steep discounts to net asset value (NAV). While some of the underlying assets were in distress, many of these fund stakes still held upside potential; as the economy recovered and markets steadily gained ground in the ensuing years, their performance gradually improved. We see this in fund performance data, as secondary funds with vintages of 2008 or later are matching or outperforming both buyout and FoFs on both an IRR and return multiple basis. This development served as a turning point for the secondary market and transformed the perception of the industry.

Median global IRR by fund vintage



A New Era for the Secondary Market

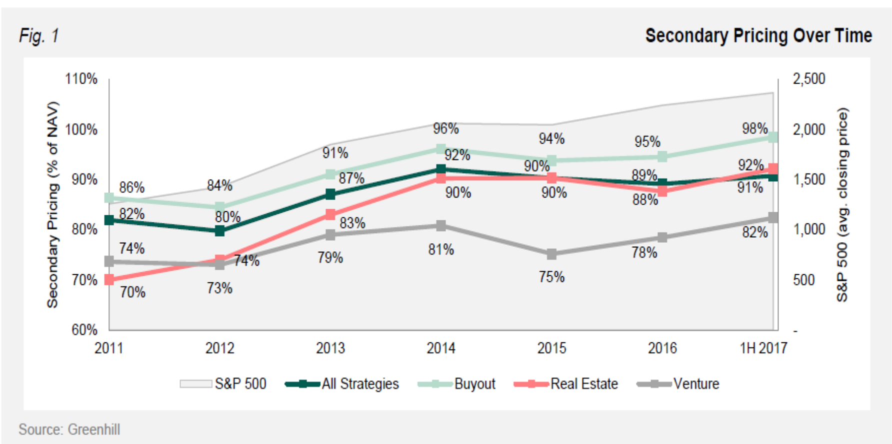
While the secondary market has matured, it is still an area in which expertise and relationships are key to securing deals. Therefore, many funds raised in recent years have been a part of a fund family from an established secondary general partner, many of which have been able to achieve drastic step-ups in their fund sizes. Indeed, the average size of secondary funds has increased by 120% over the last 10 years. Secondary funds typically have the flexibility to engage in a broad range of bespoke transactions, including complex fund restructurings, but the most common deals in the secondary market involve sales in large portfolios of LP fund interests. In these situations, buyers who are willing and able to purchase a large portion of the portfolio—or even the entire thing—enjoy enhanced bargaining power. This means that a large pool of capital can be an advantage for secondary buyers. As with other segments of the asset management industry, managers that pursue the secondary strategy are in an arms race, often consolidating their power by acquiring peers or ancillary businesses.

The concentration of the secondary market is evident in the data. From the time that the first secondary fund was raised in the 1980s through 2014, the 10 largest shops accounted for 65% of all capital raised. Since 2015, however, the share of capital raised by the top 10 firms has climbed to 79%.

While large funds dominate the space, smaller opportunities are increasingly available as more LPs utilize the secondary as a means of portfolio management. This has led to a stark bifurcation within secondary funds; while the average secondary fund size is approaching $2 billion, there lies a small ecosystem of funds in the sub-$500 million bucket. These vehicles often take a more specialized approach than their larger counterparts that allows them to target smaller opportunities.

Specialization

It’s easy to see the appeal of targeted strategies. Since buyout funds represent the lion’s share of private fund commitments, they naturally have been the targets for most buyers on the secondary market, which has led to heightened competition and pricing. Indeed, stakes in buyout funds currently transact at near-full NAV, compared to 92% of NAV for all strategies as of 1H 2017. Of course, a variety of other factors influence pricing on the secondary market—including the risk profile of the strategy, the quality of the underlying investments, the age of the fund stake, and the abilities of the GP. The less-certain outcome of venture investments, for example, is undoubtedly one of the reasons why stakes in VC funds trade at just 82 cents on the dollar.



Regardless of the reason, investors are naturally drawn to segments of the market with discounted prices. To that end, managers are increasingly raising ancillary secondary strategies that seek out specific types of funds. For managers who possess the requisite expertise, the relative discounts for strategies such as real estate and venture can enable additional alpha potential. Furthermore, managers that have the capability to acquire complete portfolios with disparate underlying assets are better positioned than peers when it comes to sourcing opportunities. Many firms with targeted secondary strategies also manage generalist secondary vehicles, allowing them to formulate more sophisticated and comprehensive bids for large, complex portfolios.

Summary of top secondaries-focused firms' activity

FIRM	TOTAL RAISED ($M)	TOTAL FUND COUNT	SPECIALIZED FUND COUNT
Ardian	$36,899.7	15	8
Lexington Partners	$31,279.8	14	4
Strategic Partners Fund Solutions (The Blackstone Group)	$26,297.0	18	10
Goldman Sachs Alternative Investments & Manager Selection Group	$24,602.5	9	2
AlpInvest Partners	$21,426.7	9	0
Coller Capital	$21,080.0	7	0
Landmark Partners	$15,644.6	36	14
Partners Group	$14,263.0	10	2
HarbourVest Partners	$12,678.7	9	0
Pantheon Ventures	$8,304.9	9	1

Source: PitchBook
*As of 10/10/2017

Landmark Partners, for instance, launched one of the first secondary funds in 1990. After initially focusing on venture capital, Landmark branched into buyouts with their third secondary fund in 1993. The firm then raised a mezzanine-focused vehicle and subsequently extended its reach into real estate with what was then known as Landmark Equity Fund VI, spawning a dedicated real estate secondary strategy that has gone on to raise seven funds. Landmark Real Estate Partners VIII is currently in the market with a target size of $2 billion.

Several firms have been drawn to the real estate niche. In 2014, StepStone joined forces with Clairvue Capital Partners on a new real estate unit, which earlier this year closed on $700 million for StepStone Real Estate Partners III. The Goldman Sachs AIMS group raised its first secondary fund in 1998, but it only recently offered a strategy-specific vehicle via Vintage Real Estate Partners.

While many secondary managers develop specialization by fund strategy, others opt to hone their skills in specific regions or sizes of the market. Lexington Partners has vehicles focused on emerging markets, for example, as well as a family of funds dedicated to the middle market. Some firms, including Ardian and Goldman Sachs AIMS, have raised funds focused on early secondary, a burgeoning area of the secondary market that focuses on funds early in their investment period.

If You Can't Beat 'Em, Buy 'Em

As the secondary market has evolved, new players have looked to enter the space; however, establishing a foothold in the market can be difficult. To that end, some newcomers have opted to acquire existing operations instead of building out their own in-house capabilities.

Carlyle provides perhaps the best case in point, entering the secondary space for the first time in 2011 via its acquisition of AlpInvest. At the time, AlpInvest had already raised a handful of vehicles, including several in excess of $1 billion. Today, AlpInvest is one of the largest buyers in the secondary market and earlier this year raised an additional $6.5 billion for its Secondary Program VI (which includes a commingled vehicle as well as separately managed accounts). While AlpInvest has stuck to generalist secondary funds, Carlyle has augmented its presence in the secondary market through its 2013 acquisition of Metropolitan Real Estate Equity Management. In 2016, Metropolitan closed on $550 million for its first secondary fund focused on real estate, and the firm is already back in the market with Fund II.

Strategic Partners serves as another prime example. Early in the 2000s, the firm began to raise more targeted strategies alongside its flagship secondary fund offerings. Strategic Partners III, which closed on $1.9 billion in 2005, was accompanied by a $300 million real estate secondary fund and a $210 million venture capital secondary vehicle. The firm continued to pursue this strategy through 2013, when Blackstone solidified its presence in the secondary market by acquiring Strategic Partners from Credit Suisse.

Tons of Funds

The FoFs strategy, which is predicated on fostering strong relationships with both GPs and LPs, also seems to be a gateway to the secondary market. FoF managers develop relationships with countless LPs and often diligence hundreds of managers each year, which can put them in a favorable negotiating position when sellers enter the secondary market. To that end, many of the most established secondary market investors, including Goldman Sachs AIMS, Adams Street Partners and Ardian, have robust FoF businesses that bolster their ability to interact with sellers in the secondary market, as well as the underlying GPs.

Increasingly, it appears that smaller FoF operations are also seeing opportunities in secondary. Hamilton Lane, which raised its first FoF in 1998, expanded into secondary in 2004 with a relatively modest $324 million fund; this year, Hamilton Lane Secondary Fund IV closed on $1.9

billion. A similar path is being followed by other FoFs, such as Portfolio Advisors, Private Advisors, Glouston Capital Partners, RCP Advisors, Altamar and Northleaf Capital Partners.

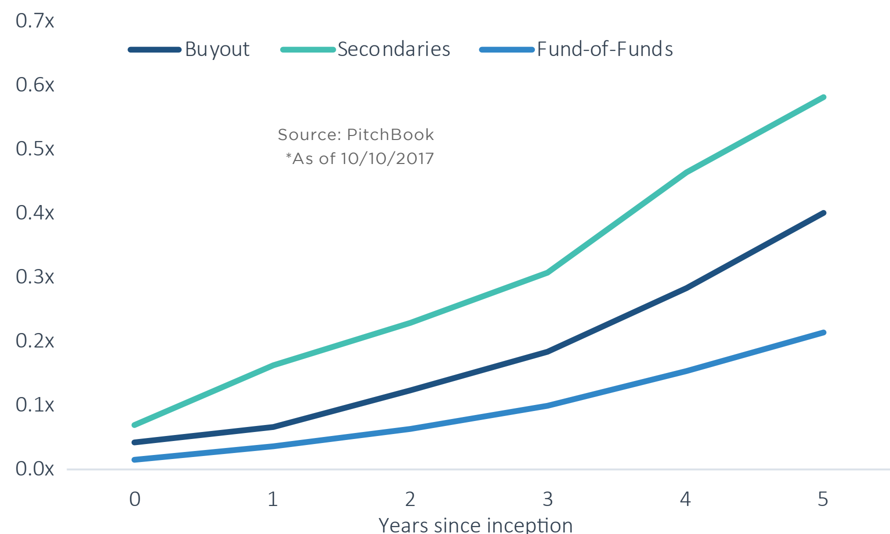
Why the Secondary Market?

Private capital investors have gravitated to the secondary market for a multitude of reasons, but perhaps the single biggest factor is the maturation of the broader private capital industry. The number of active firms and aggregate AUM in private capital funds has risen virtually unabated for nearly a decade. At the same time, investors in the space have become more sophisticated, seeking out new ways to manage their increasingly complex portfolios and to find alpha as traditional areas of the private market become more crowded.

Portfolio Management

Today, many industry professionals view secondary market transactions as a prudent way to build an initial allocation to private capital funds, as well as a means of managing a mature PE portfolio. Secondaries have long been touted as a means of mitigating the J-curve that is typically observed early in a fund's life because secondary investments often involve portfolios with mature assets, as opposed to primary funds that will spend years sourcing and executing deals, then nurturing portfolio companies. As can be seen in the accompanying chart, the average secondary fund has achieved a distributed-to-paid-in capital (DPI) multiple of nearly 0.6x by its fifth year, compared to roughly 0.4x for buyout funds and 0.2x for FoFs.

Average DPI multiple over time



When starting from scratch, it could take years for a large LP to achieve their target allocation if they are prudently allocating to primary funds. Private capital commitments should not be concentrated in a particular vintage, as this could lead to overexposure to a specific period in the business cycle. In discussing why Norway's Government Pension Fund Global would not be investing more in private equity, Yngve Slyngstad, the chief executive of Norges Bank Investment Management, dismissed the idea of allocating to private equity in part because "the duration of implementation would be so long." The secondary market is a viable solution in situations like this. Furthermore, the early secondary strategy mentioned previously can be a means of accessing funds that LPs may have missed out on during the initial fundraise; however, pricing is bound to be elevated for highly sought-after funds.

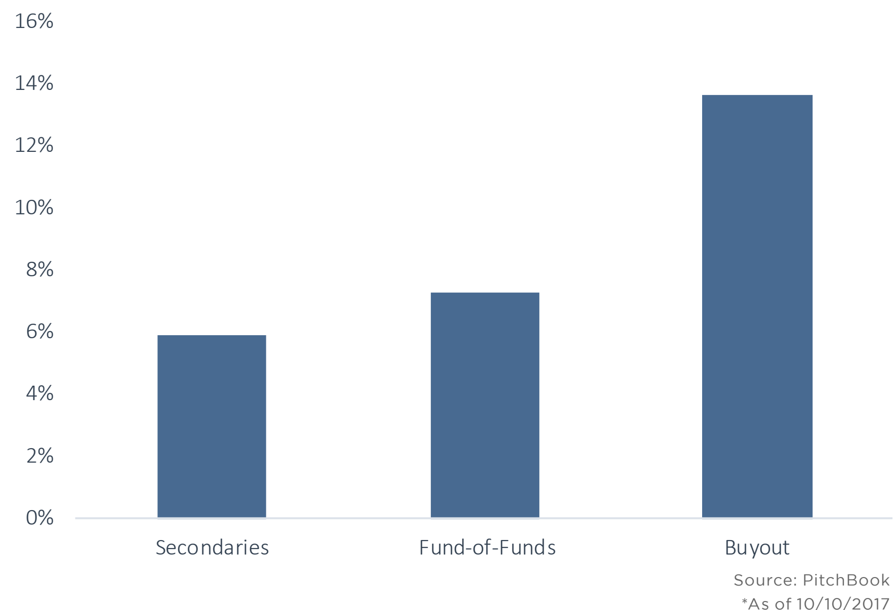
Sellers also have compelling reasons to transact in the secondary market, which is no longer solely viewed as a solution for investors in distress. Getting past the stigma of the distressed seller was a catalyst that led to the recent records in secondary fundraising totals and transaction activity. To that point, a large secondary sale has become a staple in the playbook for many institutional investors following a change in CIO, as the successor often wants to clean up the portfolio and implement their own strategy.

One notable seller in recent years has been CalPERS, which most recently sold 26 fund interests for $426 million in 2H 2016 in an effort to reduce their number of GP relationships. Furthermore, the pricing environment in the secondary market is currently very seller-friendly, so some LPs such as endowments and sovereign wealth funds (SWFs) are selling not only to generate liquidity but also to lock-in paper gains. This has been especially true for many of the SWFs in oil-rich countries, exemplified by Mubadala Capital's (a SWF based in Abu Dhabi, UAE) sale of a majority stake in its $2.5 billion private equity portfolio to Ardian.

Alpha Potential

Aside from their portfolio management attributes, secondary funds have also demonstrated the potential to outperform the broader PE industry. After a period of underperformance for mid-2000 vintages, returns began to improve with the 2008 vintage, and secondary funds for every vintage since have now outperformed both buyout and FoFs on an IRR basis.

% of funds with TVPI sub-1.0x (2001-2013 vintages) by fund type



Source: PitchBook
*As of 10/10/2017

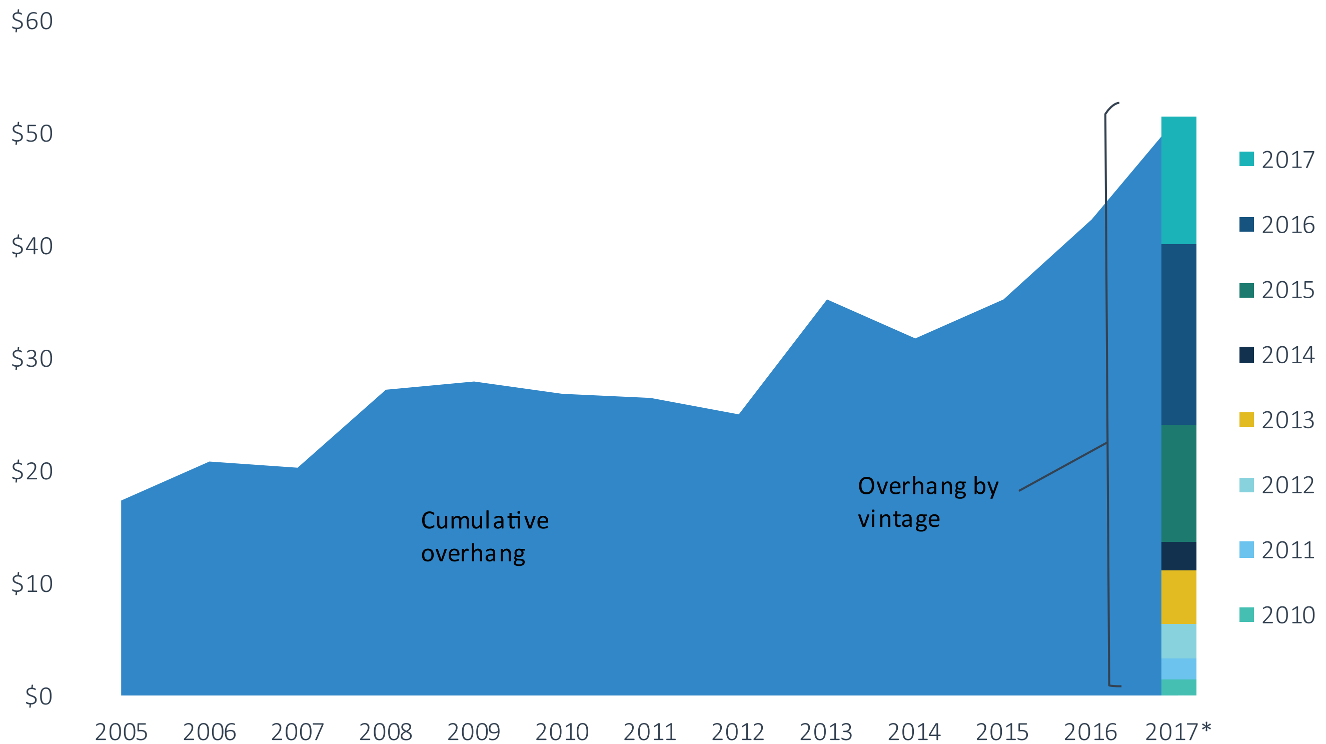
Additionally, secondary funds raised since the financial crisis have returned slightly higher TVPI multiples than their buyout and FoF peers. While outperforming on an absolute basis, secondary funds also boast lower loss rates and lower return volatility than both buyouts and FoFs. When looking at 2001–2013 vintages, nearly 14% of buyout funds have posted a TVPI multiple less than 1.0x, compared to only 6% of secondary funds. Furthermore, secondary funds exhibit a tighter spread between the top and bottom IRR quartiles than their counterparts. We see this as being driven primarily by two attributes of secondary transactions.

First, compared to both primary funds and FoFs, investors in the secondary market enjoy greater transparency into the underlying assets/portfolio companies. Managers of secondary funds can perform due diligence on existing portfolio companies to gain a clear picture ex ante of the fund's potential return profile. Additionally, as previously mentioned, secondary funds provide the ability to achieve diversification across a spectrum of elements, including vintage years, strategies, managers and geographies.

More All-Time Highs on the Horizon?

Interestingly, secondary fundraising and dealmaking were trending in the opposite direction from 2014 to 2016, resulting in a rapid buildup of dry powder. While dealmaking rose to an all-time high in the first half of 2017, it has not been enough to put a dent in dry powder.

Secondary capital overhang ($B)



Source: PitchBook
*As of 10/10/2017

With virtually every established secondary shop having raised at least one fund in the last two years, a big question is whether the fundraising momentum can be sustained. One key factor to keep in mind is that unlike many other areas of the private capital industry, the secondary market is still fairly underdeveloped and represent a scant proportion of the potential market. To that end, fundraising could continue apace for several years and still represent a sliver of the potential market. More than 60 secondary funds are currently in the market targeting more than $25 billion in aggregate capital, and they have already closed on $8.4 billion. Of course, continued inflows into secondary funds could result in heightened competition for deals and higher pricing, which could put downward pressure on secondary funds' returns.