PitchBook

Primer on Private Market Access Points

How institutional investors allocate to private markets

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Key takeaways

- The optimal strategy for an LP to access the private markets depends on several idiosyncratic factors, including size of portfolio, governance, desired in-house resources to allocate to the effort and expertise of the in-house investment team.
- The most foundational and common private market relationship is the primary fund structure: An LP commits money to a GP's fund.
- Funds of funds (FoF) bring simplicity to the allocator but also added fees and the potential risk of overdiversification. They tend to be used by small allocators unable to build a diversified portfolio as well as LPs pursuing strategies that are difficult to access and diligence.
- For investors that lack expertise and administrative support to manage an alternatives program, other outsourced options exist outside of the commingled fund structure. These include investment consultants, separate accounts, funds of one and outsourced chief investment officers (OCIOs).
- In the illiquid world of private market investing, secondaries have matured into an investable strategy and viable portfolio management tool. Secondaries funds bring cost and diversification benefits to allocators. From a seller's perspective, they also provide an option for LPs to separate themselves from their long-term commitments.

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Introduction

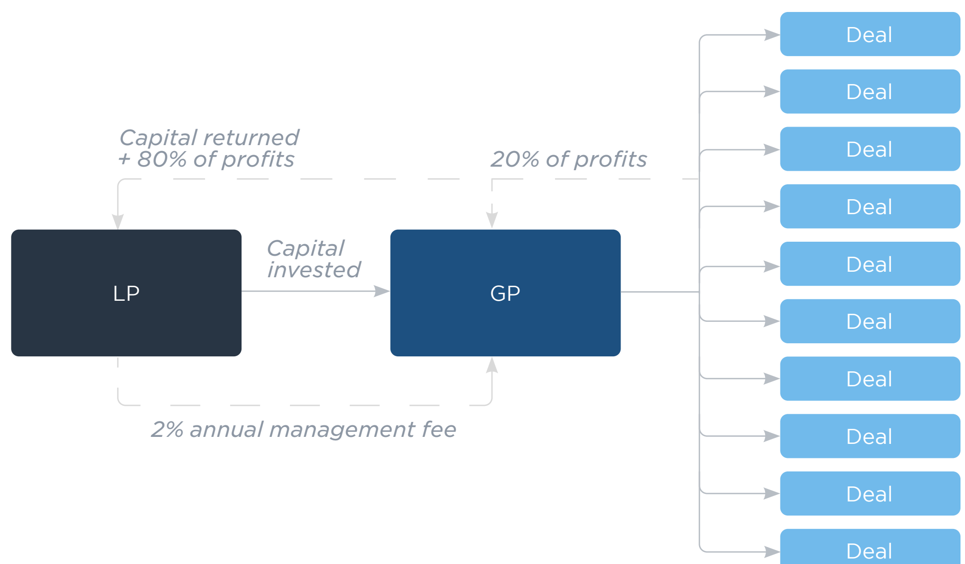
How does an investor gain access to the private markets? The answer to that question depends on a variety of factors. The types of exposures investors are trying to achieve. Their objectives. The size of their investment pool. The human and budgetary resources they are willing to apply to proper diligence and monitoring. The governance structure and decision-making framework under which they operate. And many more characteristics and behaviors.

As the private markets have matured, they have transformed from an extremely exclusive club to one in which even public market investors can gain exposure by buying the listed shares of general partners. This note is designed to describe the different access points institutional investors have into the private markets and report on the features, users and providers of each offering.

Primary fund commitments

The relationship between limited partners (LPs) and general partners (GPs) within a fund structure is foundational to the private markets, matching providers of capital with managers of commingled funds. Nearly every other entry point to these markets is based upon this relationship. The LP/GP terminology is borne out of the legal relationship these entities have to the investments. At the most simplistic level, GPs are the decision makers that are legally responsible for the investments, tasked with finding, managing and exiting them. They usually provide only a small portion, often 1% to 2%, of the investable capital, however. LPs, on the other hand, are barred from influencing the investment management process except in a high-level advisory capacity; in exchange, they have only limited liability if the investments fail. In other words, they can only lose the amount they invest and cannot be sued for additional sums. LPs provide the majority of the capital to private funds and essentially hire the GP to act as their agent during the life of the fund.

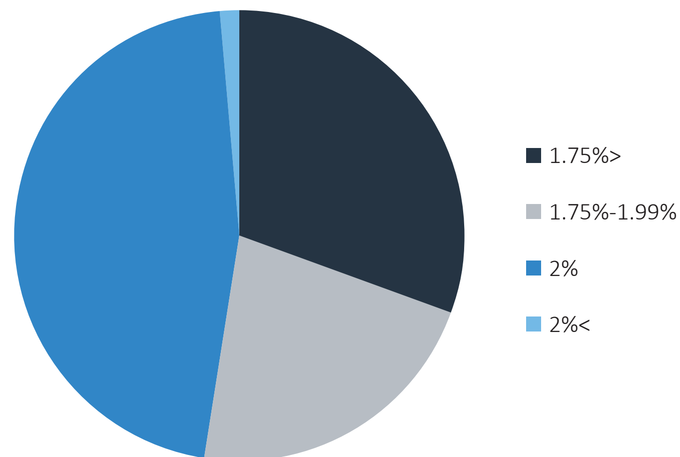
Primary fund commitment structure



Source: PitchBook | *For illustrative purposes only*

Every quarter, LPs pay a management fee to the GPs; in addition, GPs are incentivized by earning a percent of the ultimate profits of the fund. The "2 and 20" fee structure refers to a 2% annual management fee (i.e., if an investor commits $100 million to a GP, they pay $2 million in an annual fee every year) and a 20% incentive fee, also called carried interest (i.e., if they buy a company for $50 million and sell it for $75 million, the GP receives 20% of the $25 million profit, or $5 million). It is generally accepted by industry participants that this structure properly incentivizes the GP to align its interests with those of the LPs, hopefully leading to high profits within the confines of the strategy. While 2 and 20 remains the most common fee structure, these terms—particularly the management fees—are becoming more fluid and can vary depending on the size and strategy of the funds as well as factors such as the timing and size of the LP's commitment.

Buyout fund management fees (2015 to Q1 2020)



Source: PitchBook | **Geography:** Global

The time commitment for primary fund allocations is fairly straightforward. While terms may vary, typically a fund's life span is comprised of a five-year investment period and then another five-year period in which GPs harvest the investments so as to distribute capital and profits back to LPs. Most funds also have the option for two one-year extensions to the life of the fund to ensure exits are not forced during a period disadvantageous to profits. As we illustrated in the 2019 Annual US PE Breakdown, there can be a wide range around actual holding periods, but most show an expected timeline that resembles this construct in their limited partnership agreements (LPAs).

Primary funds may invest their assets across a gamut of strategies. Not only can they differentiate their approach by seeking venture, buyout, real estate, or some other type of transaction, but even among buyout shops, one can find funds varying their focus by geography (global or some specific locale), by sector (one or a few economic sectors such as energy or consumer) and by size (such as specializing in companies with an enterprise value under $250 million). In addition, some GPs have preferred ways to add value, such as focusing more on financial engineering or roll-up strategies.

Some examples of recently raised primary funds and their different approaches

Fund	Approach	Fund size ($M)
Blackstone Real Estate Partners IX	Large deals, global, opportunistic real estate	$20,500
Apax IX	Platform and add-on investments, global, buyout, sector generalist	$9,000
Crescent Mezzanine Partners VII	Mezzanine provider to PE deals, large deals, US, sector generalist	$4,600
New Enterprise Associates 17	Over 100 non-control investments, typically US, VC, healthcare and IT sectors	$3,600
Generation IM Climate Solutions Fund III	Small to middle-market deals, global, variety of approaches (VC, mezzanine, buyout), impact investor	$1,000
Gilde Healthcare Services III	Growth equity, healthcare sector, Europe focus, small revenue-generating companies	$226 (€200)

Source: PitchBook

Investor considerations

Even if an investor qualifies as an accredited investor,[1] the amount they wish to invest in private market funds may not be substantial enough to allow them to assemble a diversified portfolio of primary funds. In many cases, funds have a minimum commitment size. This threshold rarely goes below $1 million in a PE fund, for example, and can be set much higher. An investor with $100 million in assets may have a 10% allocation to PE, which translates to $10 million. It would be difficult to diversify this sum across venture and buyouts, global and regional geographies, middle-market and mega-deals, and across vintage years. Building a direct program involves identifying and examining numerous primary funds and cutting them down to a short list of those requiring diligence, legal negotiation and eventually monitoring. Assembling and monitoring a portfolio of primary investments could overwhelm a smaller investor and tempt them to seek other means of gaining access to the diversifying benefits of private market investing.

On the other hand, exceptionally large investors face their own dilemma. They may wish to access VC and small- to middle-market buyouts, but they often encounter sub-$1 billion fund sizes and a single investor limit of 20%, so primary fund commitments may not be impactful at the total portfolio level. In addition, it may not be worth the LPs' time and dedication of resources to diligencing and negotiating sub-$20 million commitments when their total assets are in the tens or hundreds of billions.

1: This is a term defined in Rule 501 of Regulation D of the SEC code. The rule includes many parts, but one of the key provisions is that individuals must have a net worth of $1 million, not including the primary residence, and institutional investors such as pensions and nonprofits must have total assets in excess of $5 million. The purpose of the rule is to allow GPs to avoid certain registration requirements because they are only selling to people who should understand the risks of these investments.

Beyond the size of an investor's asset pool, there are several other considerations that might make primary fund investing a poor fit for some LPs. Many potential LPs have the assets but only a limited investment staff, which may not have the expertise or resources to properly diligence and monitor a diversified portfolio of private market investments. In addition, many recognize that they need help identifying and accessing best-in-class private market funds. Alternatively, they could face public scrutiny for the travel program needed to perform the onsite visits that best practices recommend to sufficiently diligence new investment ideas. Finally, the governing committee of an allocator may not have the patience or expertise to approve a plethora of different funds every year. With quarterly or even semi-annual meetings, it may be difficult to reach investment decisions in a timely enough manner to meet closing deadlines.

These limitations are common elements supporting the demand for a variety of access points beyond primary fund commitments. The following sections discuss other options for investors seeking to participate in the private markets.

Funds of funds

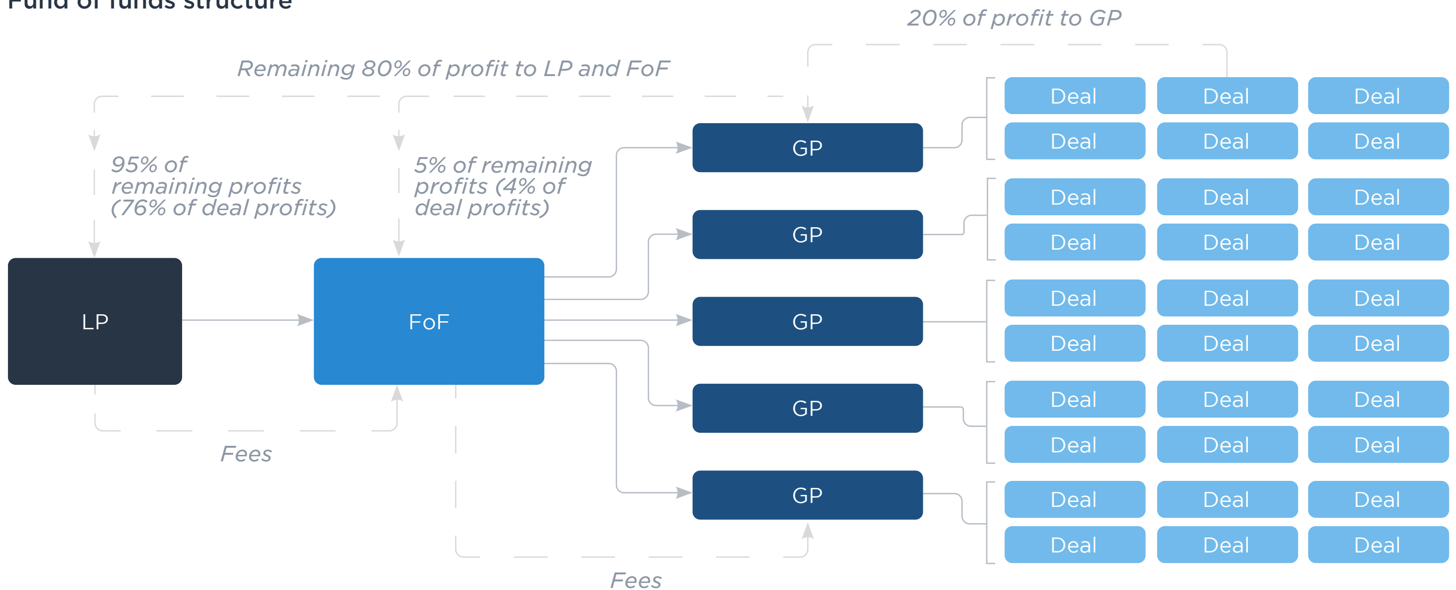
There are two common rationales for selecting FoF as an access point to private markets. The first is pursuing the expertise of a well-resourced firm to achieve diversified exposure to private markets. The second is seeking to invest in an area of the private markets that is more difficult to enter or diligence. FoF focused on VC are a prime example of serving the latter, as the best VC GPs will often not accept commitments from new LPs when existing LPs offer more than enough capital to enable the GP to fulfill its fundraising objectives. In addition, using a VC FoF allows massive investors to make one meaningful commitment rather than numerous small commitments that would each have minimal impact on total portfolio performance.

Examples of FoF that have raised capital in the last several years

GP	Offerings	AUM ($B)
HarbourVest Partners	Diversified FoF, secondaries, separate accounts, specialty FoF	$68.0
Consumer Technology Association	VC FoF focused on women, people of color and other underrepresented startups and entrepreneurs	$10.0
Greenspring Associates	VC FoF, VC secondaries, specialty FoF	$9.8
Mercer	Investment consultant-managed diversified FoF	$3.1
North Sky Capital	Impact fund secondaries, specialty FoF	$1.2

Source: PitchBook

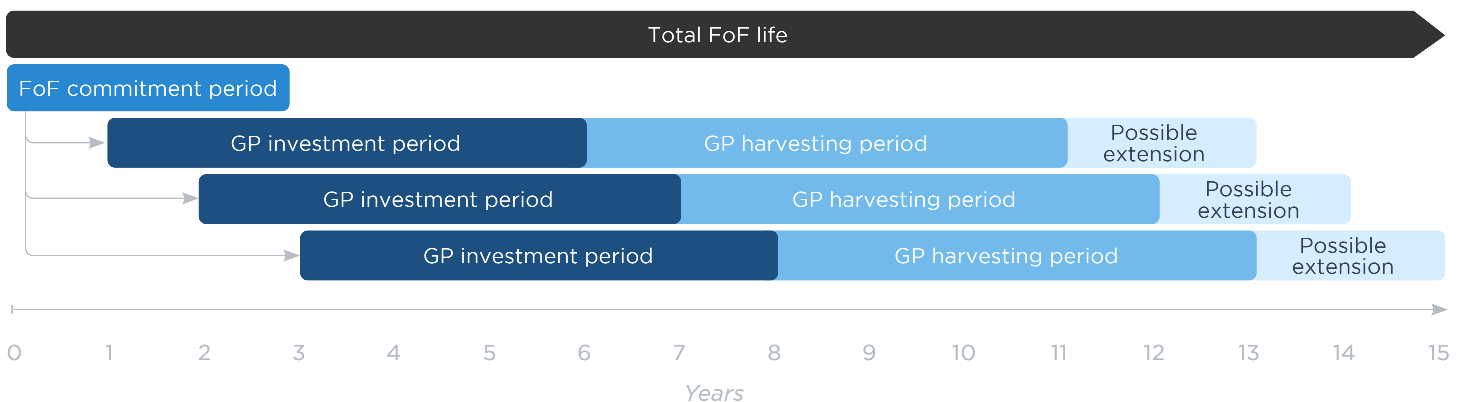
Fund of funds structure



Source: PitchBook | *For illustrative purposes only*

The mechanics of a FoF are as follows: An LP allocates to one FoF[2] that is also accepting commitments from other LPs to form a pooled vehicle. The FoF GP then makes direct commitments to a number of private market funds. Some sign on with perhaps a dozen GPs, while others hire over 100 distinct managers.[3] Often this depends on the assets gathered (more assets to invest, more funds) and the investment strategy (many FoF are now including secondaries and co-investments, increasing the number of investments made by the fund). Then each of the funds to which the FoF GP commits funnels that capital into its own deals. At a minimum, this will result in exposure to over 100 companies via one FoF commitment. At the extreme, it could be thousands.

Typical lifespans of a fund of funds



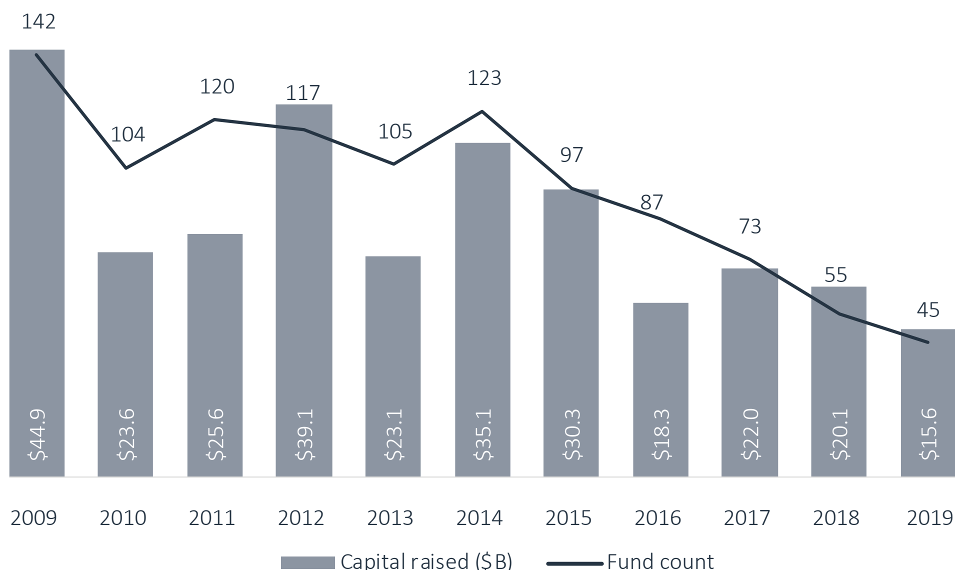
Source: PitchBook | *For illustrative purposes only*

2: The LP may invest in more than one FoF, of course, and may also have a blended portfolio of FoF and direct fund commitments. For the illustration, this is just one of the LP's investment selections.
3: This figure is based on a fund company that had 150 funds in its 2003 vintage. That company has since scaled back its commitment count to closer to 60 funds in its global diversified FoF program.

In terms of timing, FoF have a more extended lifecycle than direct funds. They typically make commitments across three or so vintage years, which is a shorter "investment period" than their direct counterparts have, but then those underlying funds have five years to invest their commitments, which means the FoF may be drawing down capital for at least eight years. Considering that the underlying funds from multiple vintages have another five years to harvest their investments, which really takes eight from the perspective of the original LP, the life of a FoF could easily surpass 15 years.

While the advantages of using FoF are significant for certain investors, there are two main concerns many have about the approach: the second layer of fees and overdiversification. While FoF GPs do not have a 2 and 20 fee structure, they do usually have some level of management and incentive fee.[4] LP net performance in FoF will reflect a deduction from the underlying fund commitments that do charge 2 and 20. FoF offerings have done some work to mitigate the expense by investing portions of their funds in secondaries (the purchased stakes may have reached a point where fees step down following the investment period), making co-investments and possibly even negotiating somewhat better terms with the GPs. The additional layer of fees, compounded by exposure to potentially thousands of deals, which ultimately just approximates the overall return of the private market, makes it difficult for FoFs to outperform the private market universe. These burdens have caused some who had typically been FoF LPs to seek other access points into private markets and some FoF GPs to adapt their offerings to provide products that have a higher likelihood of success than a broad FoF program. The search for other avenues is clear in this graphic taken from the 2019 Annual Private Fund Strategies Report.

FoF fundraising activity



Source: PitchBook | **Geography:** Global

4: The typical PE FoF collects 1% in management fee and 5% in incentive compensation.

Separate accounts and funds of one[5]

Separate accounts and funds of one cater to LPs seeking a more bespoke option than a typical FoF. In this case, a massive investor will hire a FoF firm to invest its assets in a way similar to the main FoF program, but the LP's assets are not commingled with those of any other. Separate accounts are essentially limited OCIO arrangements (see section on page 9). There is an advisory agreement between the LP and the FoF firm, but investments are all made directly in the name of the LP. Funds of one, on the other hand, create a new legal entity wherein the FoF acts as the GP making commitments in that entity's name, but only one LP feeds into the fund. For tax reasons, FoF may prefer the fund of one because it can report any incentive fees received as capital gains; in the separate account scenario, fees would only be deemed ordinary income. As these relationships are more time-consuming per client than a commingled fund, FoF will typically only accept these mandates for substantial investment sums, with minimums of $100 million being the norm.

These relationships are established for a few reasons. The first is economics: The FoF firm is often willing to negotiate fee terms given the administrative ease of one reporting relationship with a single LP committing the entire pool of capital. In some cases, the dollar amount is enticing enough that the LP pays no incentive fees to the FoF firm for the separate account or fund of one. In addition, separate accounts typically charge a fee on invested capital, not committed capital, so management fees are lower over the life of the relationship than they would be in a FoF.

Customization is another feature of these structures. In some cases, LPs will have specific preferences about how they want their private market exposures weighted, and by having a direct relationship with the FoF, they can tailor a portfolio that more closely matches their needs. This may even be adaptable over the life of the relationship, so the portfolio can attempt to be more opportunistic than a commingled FoF may have room to be. Transparency is also improved in these relationships. It is often difficult for LPs to truly know their exposures when the FoF directs their commitments. When a deal in an underlying PE fund has a massive success or an utter blow-up, for example, the FoF investor often won't know that it has a piece of that deal.

Finally, there are a couple of possible advantages that come from having only one name associated with the commitments in either scenario. An LP wishing to sell down a portion of its private market portfolio can select which positions to sell rather than putting up a whole FoF stake. FoF stakes tend to sell at bigger discounts in the secondaries markets than direct stakes, as buyers are forced to take everything and the funds last for years longer than direct funds. From a worst-case scenario standpoint, should the FoF firm fail, the fund commitments can much more easily be transferred into the LP's hands rather than having to break them up among a variety of interested parties.

5: For the purposes of this note, we assume that the implementation of these approaches will be into funds, though some primary GPs do also allow LPs to have a segregated structure.

Investment consultants

As noted previously, many institutional investors suffer from a lack of resources and, as a result, will hire a consultant to aid, in a non-discretionary capacity, on a variety of activities pertinent to the management of an investment portfolio. Consultants advise on total portfolio asset allocation, actuarial assumptions that feed into liquidity decisions, public market and alternative manager due diligence, investment recommendations, and private market commitment planning and modeling. They also calculate performance measurement for clients, ensuring accuracy and consistency in the calculations over time. Investment consultants have larger and deeper staffs than most institutional investors, so they can bring scale and expertise at a cost to LPs that is less than that of bringing on full-time staff.

Consultants advise on many billions of dollars earmarked for private market funds. For this reason, they are often called gatekeepers. They identify, diligence and recommend funds to institutional investors the world over, many of which accept those recommendations with minimal additional work. Although the consultants are not acting in a discretionary capacity in recommending funds to clients, they wield significant power in the industry by making recommendations that result in substantial commitment activity. In some cases, consultants are able to negotiate fee breaks. If their roster of clients commits a certain cumulative dollar amount, the management fee will step down for the whole roster.

Select investment consulting firms

Investment consultant	Geography and scope	Size
Mercer	Global consultant in health, retirement, investments, and talent; fully owned by Marsh & McLennan	25,000 employees in 44 countries
Wilshire Associates	Full-service investment consultant, global	350 employees
Meketa Investment Group	Full-service investment consultant, private markets specialty, US offices only	28 employees

Source: PitchBook

Outsourced chief investment officers

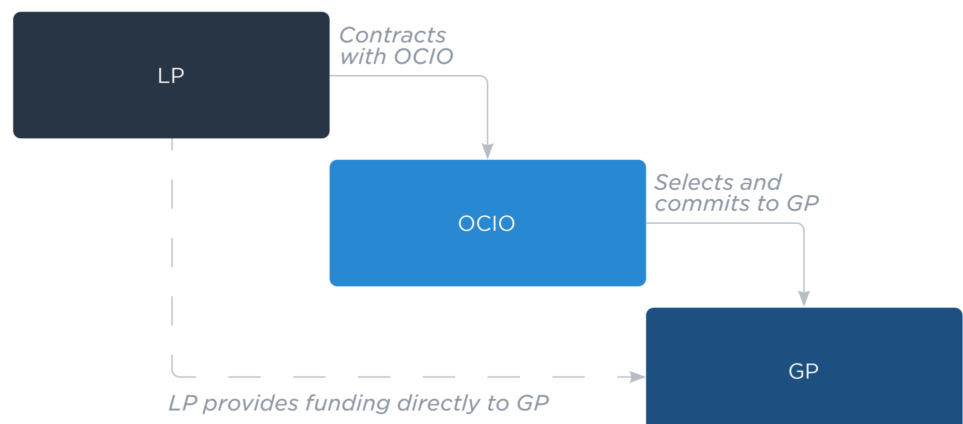
Some LPs without enough staff, expertise or resources to run their own private markets program—but still wanting access to the return profile of private assets—grant individuals or firms with the discretion to act on their behalf, thereby outsourcing the chief investment officer function. Some institutional investors will do this with their entire pool of assets in a buy rather than build approach to investment oversight, but more commonly they will hire outside expertise for what is perceived as the more difficult portions of their portfolio: the alternative assets.

One major difference between an OCIO and a FoF is the legal agreement. The OCIO will make commitments on behalf of the LP but does not itself make capital calls from a fund structure. Also, while LPs can terminate an OCIO at any time, any GP commitments the OCIO made on behalf of the institutional investor will live on for the LP or a new OCIO to service and monitor. The OCIO relationship is akin to the separate account set-up described earlier, the major difference being the players offering the services. Industry terminology has begun to converge more often around the term OCIO except when a true fund manager is the party hired.

OCIO relationships vary almost as widely as the number of such relationships that have been formed. An OCIO could be a single person reporting to the client's investment committee but otherwise making decisions as if they were internal employees with discretion over the institutional investor's assets. In some cases, there is not true discretion. The OCIO needs to present investment recommendations to an internal staff or oversight committee before then acting on the LP's behalf in negotiating and executing the LPAs and monitoring the investments. The OCIO may be involved in a limited scope mandate (just PE) or may be responsible for overseeing the entire portfolio of investments.

Another frequent provider of OCIO services is the aforementioned investment consultant, originally conceived as an advisor without any discretion, but who has extended its services to take on more of the administrative and fiduciary burden from under-resourced clients. The consulting firms see the OCIO trend as a way to increase revenues by leveraging work already being done and charging a price higher than advisory work would garner. They generally have a deep staff able to bring a wide and deep view to private markets and are also able to benefit from scale if they have enough clients seeking similar services. Investment consulting firm revenues have been squeezed for years, as they work in a marketplace where few asset owners are forming and pension clients are disappearing, leading to a lot of price-based competition. By taking on a deeper fiduciary relationship with and lifting some administrative burden from clients, both sides can justify an increase in fees.

OCIO model structure

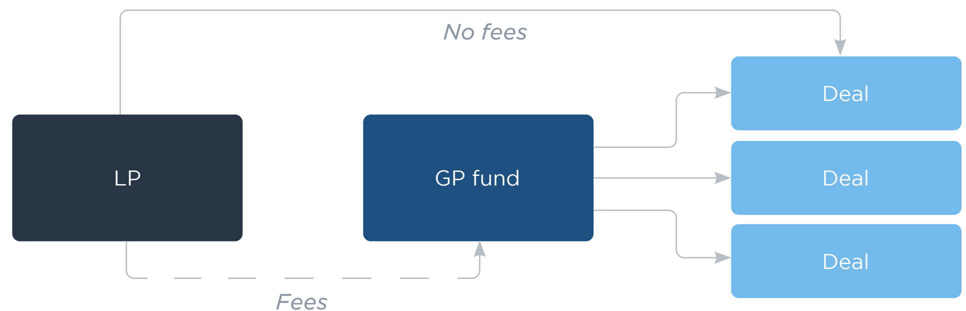


Source: PitchBook | *For illustrative purposes only*

Co-investments

Many investment committees put a laser focus on fees and seek ways to gain access to private markets at a less expensive price point. Co-investments, which allow institutional investors to invest alongside GPs outside of the typical primary fund commitment structure, offer an intriguing approach to meet this objective.

Co-investment structure



Source: PitchBook | *For illustrative purposes only*

Originally, co-investments were an offshoot of fund investing. A private market fund often has its own diversification guidelines as part of a GP's risk management toolkit. Every so often, however, the GP may identify an attractive investment opportunity that requires a check larger than it can comfortably write using the fund's available commitments. While it could seek out other GPs to be part of the deal, so-called "club deals" have a spotty track record and present potential issues of confidentiality and control. The passive participation of an institutional investor avoids those problems. Existing LPs that have already diligenced and approved the GP may be invited to take part in the deal outside of the fund structure with no fees or carried interest charged. Having some portion of its share in the lower-cost co-investment boosts the LP's end return on the deal.

While this arrangement sounds like a great deal for LPs, there is one major difficulty: GPs usually give just days for the LP to examine the opportunity and decide whether or not to participate. While some investors have enhanced their staffing to be nimble enough to evaluate and agree to these offerings, many LPs do not have the bandwidth or experience to drop everything and properly assess this sort of deal in an abbreviated period of time. This limits the number of LPs that can realistically take advantage of these opportunities, which has given rise to funds created purely to invest in co-investments. One of the ways FoF companies have evolved to stay relevant to LPs is to develop the capabilities to quickly evaluate co-investment opportunities. Their co-investment funds are able to perform diligence on co-investment deals coming both from their own stable of GP commitments as well as any opportunities that the fund's LPs bring to them. These funds end up resembling direct funds by investing in a diversified set of individual deals, but with a typical fee structure of 1 and 5,[6] a price point significantly lower than a direct fund commitment.

6: "Co-investment: Is It the Answer?" Private Equity International, Isobel Markham, June 3, 2019

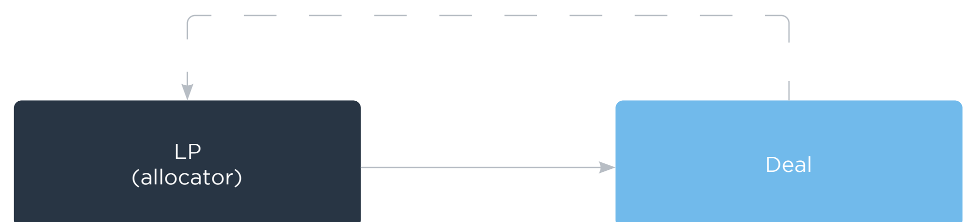
Another vehicle that has emerged from the co-investment phenomenon is the GP-sponsored co-investment fund, often called an annex fund. This is designed to lock up a pool of commitments to automatically invest in the GP's own deals should any arise that are too big for the main fund. LPs that sign up for these vehicles no longer have the opportunity to assess the deals going into the fund; they are simply signing on for increased exposure to a GP with whom they are already comfortable. The terms on these co-investment vehicles will vary, but they will typically offer significant savings from the main fund terms. KKR raised its 2010 annex fund,[7] for example, with no management fee but still expected to collect carried interest on profits.

There have been persistent concerns among potential co-investment participants that GPs do not offer their best ideas as co-investments; they would naturally prefer to collect full fees and carry on their strongest performers, so why offer up a share that will diminish their own revenues and profits? A mitigating factor to this complaint is that it assumes that they know upfront which of their investments are better and thus are capable of identifying the duds that should be off-loaded to others. In general, there are incentives for GPs to make LPs happy, particularly if they hope to raise successor funds from the same pool of investors.

Direct investing

Some LPs have decided to build rather than buy their private market exposure by making direct investments into companies, thereby removing GPs from the equation. The most notable example is CPPIB, or the Canadian Pension Plan Investment Board, which has made sizable investments into companies such as Ant Financial, Petco Animal Supplies and Chesapeake Energy. Commanding over C$450 billion, this group can hire qualified staff able to acquire, manage and exit individual companies at a discount to what they would pay a GP. The flipside is that in acting in this capacity, the investor is no longer "limited" in its liability, as it is managing the assets itself.

Direct investment model



Source: PitchBook | *For illustrative purposes only*

7: "KKR Annex Fund Foregoes Management Fee," Infrastructure Investor, Kevin Ley, March 15, 2010

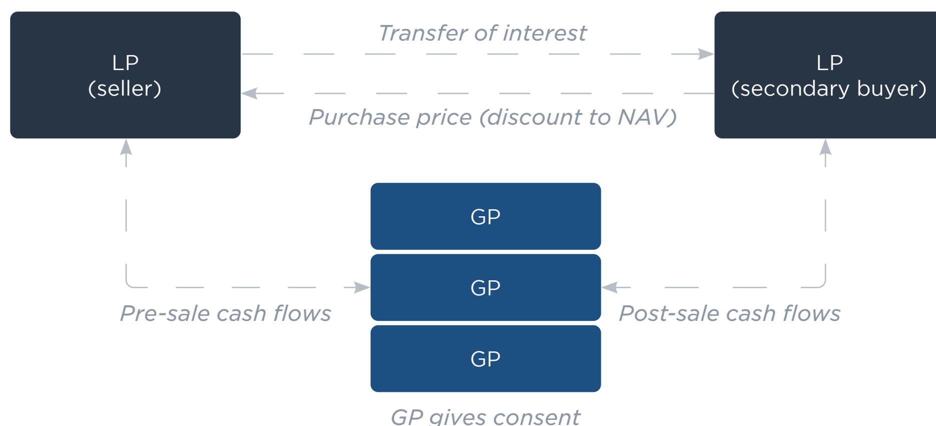
Recognizing that buying and managing companies requires a skillset that a public pension budget may find it difficult to afford, some of the groups looking to invest directly have created separate investment offices that aren't subject to the same disclosure requirements, such as the Freedom of Information Act (FOIA).[8] This relationship also allows public pensions to avoid salary caps and consider the expense an investment management fee. The pension then "hires" this captive group to manage its direct portfolio for a fee less than a PE firm would charge, but more than it would cost if it had stayed entirely in house. In 2019, CalPERS announced that it would be exploring this approach, the rationale for which is footnoted here.[9]

That said, in many cases, asset owners going direct are not investing for control positions, relying on other investors or company management to operate the company to some plan agreed upon by the partners in the deal. CPPIB does continue to make investments into funds but has made upward of 600 direct investments since initiating the program over 20 years ago. In light of the CPPIB program as well as a similar approach by the Ontario Teachers' Pension Plan, this method of direct investing is often called the Canadian Model.

Secondaries

Another way for LPs to gain access to private market exposure is to commit to secondaries funds. A secondaries transaction, in private market parlance, is simply the sale of an LP's interest in a fund to another LP.[10] While market participants have certainly found ways to complicate this extremely opaque marketplace, the root is that an LP who has committed to a long-term investment has sought the sale of that investment, and there are investors who are eager to purchase those seasoned stakes. This is the secondaries market for PE.

Flow of secondaries transaction



Source: PitchBook | *For illustrative purposes only*

8: This 1967 rule allows, among other things, citizens to ask any US public entity to provide documentation pertaining to its operations. For more information, go to foia.gov
9: "Exploring a New Private Equity Model," CalPERS, October 19, 2018
10: We acknowledge the existence of direct secondaries—investors buying companies out of PE portfolios rather than the whole fund stake—but have chosen to limit the scope of this note to the more basic transaction.

How are these positions priced? After all, there may still be capital calls to come, but there are acquired companies already in the portfolio, too. The secondary buyer takes the current value of the portfolio holdings, as reported by the GP, determines the potential of each investment and of the fund as a whole, and puts a value on the LP's stake in the fund. The bid is usually shown as a discount to the GP's stated net asset value (NAV). For example, if the portfolio is currently marked at $10 million, the bid will come in as 90% of NAV, or $9 million. The purchaser will be responsible for all capital calls following the transaction date but will also be entitled to all distributions from that point forward.

Most large portfolios of LP interests are auctioned to the highest bidder in an attempt to even the informational disadvantage LPs have when it comes to pricing the funds they are offering for sale. Buyers thus pay top dollar for these holdings, making it difficult to realize outsized returns on the purchase. In order to improve the return potential, secondaries purchasers often apply leverage to the portfolio to shore up the ultimate investment returns. Small positions or single fund sales, on the other hand, are often privately negotiated, avoiding the auction process, and may not see many competitive bids. GPs willing to shop these smaller positions may not need leverage, as the discounts they pay leave plenty of upside on their own.

Sell side

While every accredited investor committing to private market funds should have the sophistication to understand the long-term nature of commitments to these asset classes, in the course of a fund's lifetime, there may be valid reasons for an LP to seek the sale of some or all of the fund stakes it has accumulated. Historically, the primary reason was assumed to be distress. In that scenario, an LP would find itself short on cash and need liquidity from the illiquid portion of its portfolio in order to meet obligations. Harvard became a prime example of this in 2009 when cash was in short supply due to building projects on campus and margin calls from the investment portfolio.[11] While it did shop the PE portfolio, the university felt the price was too dear and so devised alternative liquidity sources. Another reason to sell private market stakes is if the asset owner changes direction, as was the case with Dayton Power & Light in 2005 when new management determined that a $1 billion portfolio of PE interests was not core to the business.[12] The sale to AlpInvest Partners and Lexington Partners was the largest secondaries transaction of its time.[13]

Recently, however, it has become more acceptable to seek the sale of GP interests as part of routine portfolio management activities. Perhaps a chief investment officer recognizes that demand for a strategy is strong, making it a good opportunity to sell that investment for a more than fair price. Or perhaps the investment committee decides that while it wants to continue to have PE exposure, it does not want to do so via FoF any longer, so that portion is carved out and put up for sale. One reason prices for LP stakes have risen in recent years is because sellers are more likely in this scenario to walk away from a disappointing price when they are not compelled to sell.

11: "Harvard: The Inside Story of Its Finance Meltdown," Forbes, February 26, 2009
12: Disclosure: Hilary Wiek was formerly a Director at MVE Inc., the investment subsidiary of Dayton Power & Light.
13: "DPL Agrees to Sell Private Equity Investments," Business Wire, February 14, 2005

Buy side

Another major reason why the price of secondaries transitions has risen (or the discounts have shrunk) is essentially arbitrage. Early entrants into buying secondaries were able to have their pick of stakes with minimal competition. Seeing the returns early funds garnered, larger funds and more buyers have entered the game and sellers have become more sophisticated, hiring brokers to auction their stakes for a better price. There is a severe information advantage on the side of secondaries buyers, as they can see a much wider swathe of the private markets, but the auction process helps to assuage the imbalance.

One advantage of being a secondaries buyer is that, unlike direct fund commitments, the time to harvest has been moved forward, contributing to the J-curve mitigation benefits of buying secondaries. Secondaries are often purchased after many of the fund's investments have already been made, so the time to exit is shorter than if the LP had made a primary commitment at the start of the fund's life. In addition, entering at this stage allows LPs to buy into a known portfolio of investments and decide what they'd be willing to pay for those assets, whereas LPs investing in primary funds cannot know yet what investments the GPs will make, which is why these funds are often called blind pools at the time of commitment. Some investors into secondaries see an advantage in buying multiple prior vintage years in one purchase. Because the acquisition is priced at a point in time reflecting market moves since those vintages, however, the diversification benefit is not as great as it may initially appear.

Firms offering secondaries funds remain scarce for several structural reasons; because the number of them is low, fundraising figures can see big swings year to year depending on when the few participants come back to market. One reason for this shortage is that secondaries require a specific skillset that is not easy or quick to build. Not only does a secondaries fund manager need to have a proprietary method for sourcing deal flow from LPs, it also needs to differentiate itself from other buyers to compete on something other than price. In addition, it needs to have the ability to evaluate dozens of GPs, have deep knowledge of hundreds of funds and thousands of portfolio companies, and know how to put a value on a portfolio of funds that will entice the LP and still ensure profit for the secondaries investor. Because these prerequisites require such depth across multiple specialties, the number of fund managers offering such products has not expanded nearly as much as areas of the private markets making direct portfolio company investments one at a time.

Another oddity of the secondaries market that keeps a constraint on secondaries fund proliferation is that, through clauses in the LPAs, GPs have typically retained the power to approve or deny the sale of LP interests. While GPs typically want to keep their LPs happy, they do see some LPs as more desirable partners than others. In order to be a successful secondaries buyer, a secondaries fund manager may need to convince a GP it offers an advantageous partnership. This is a fairly easy sell if the secondaries manager has a FoF that might make future primary fund commitments. In some cases, however, the GP will deny the transaction, because it sees the secondaries manager as a competitor potentially seeking to gain access to the GP's intellectual property. This can be a disruptive issue when secondaries funds attempt to buy a portfolio of interests from an LP; often large portfolios will have to be broken up among buyers that GPs will allow.

Summary

Depending on a wide variety of factors, solutions exist in the private markets to satisfy a broad range of requirements. We summarize here some thoughts about who might select each sort of strategy and factors an allocator should consider when embarking on a private market program.

		Resource considerations for allocators			
		Asset requirements	Time for investment assessment	Expertise needed to allocate	Maintenance interactions
Fund options	Primary fund commitments	Low to Medium	Months	Medium	Quarterly
Fund options	FoF	Low	Months	Low	Quarterly
Fund options	Separate accounts/Fo1	High	Months	Medium	Frequent
Fund options	Secondaries	Low	Months	Low	Quarterly
Advisory	Consultant	Low	N/A	Low	Frequent
Advisory	OCIO	Low	N/A	Low	Frequent
Non-fund options	Direct	High	Weeks	High	Constant
Non-fund options	Co-invest	High	Weeks or days	High	Frequent

		Investment characteristics				
		Management fee	Incentive fee	Other fee	Duration of investment (est)	Amount of liability
Fund options	Primary fund commitments	Yes	Yes	No	10-12 years	Limited
Fund options	FoF	Yes	Yes	Underlying fund fees	13-16 years	Limited
Fund options	Separate accounts/Fo1	Yes	Maybe	No	13-16 years	Depends
Fund options	Secondaries	Yes	Yes	Underlying fund fees	10 years	Limited
Advisory*	Consultant	No	No	Yes, varies by services rendered	At will	Limited
Advisory*	OCIO	Yes	Yes	No	At will	Depends
Non-fund options	Direct	No	No	No	6 years	Not limited
Non-fund options	Co-invest	No	No	No	6 years	Not limited

*The advisory types will result in private market exposure, but the fees and durations depend on which vehicles are eventually chosen. The information here is strictly for the relationship with the advisor.