DWS

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The best of both worlds?

The rapid growth of a secondary market in private equity has created new opportunities. It is not without risks, however.

_ The growth in the secondary market has made the whole private-equity asset class more liquid.
_ We believe there is a way to get the best of both direct and secondary investing.
_ A tactical strategy that focuses on "stock picking" later-stage investments within an existing PE portfolio may help.

Mark McDonald
Head of Private Equity

Over the past 20 years, private equity (PE) has grown to about $3 trillion under management globally. Traditionally, investors – called limited partners (LPs) – have mostly gained exposure to underlying companies either via funds, which own companies directly, or funds of funds (which aggregate many PE-fund investments into a single product). Collectively, investment into a PE fund from "day one" is known as the "primary" market. Over the past decade, however, we have also seen growth of the PE "secondary" market – which specializes in buying funds and portfolio stakes second-hand from investors desiring early liquidity in these funds.

The private-equity market continues to be an inherently long-term, illiquid asset class, as evidenced by an average fund life of 15 years. With the increasing prevalence of secondaries capital in the market, LPs have been able to sell their stakes in private-equity funds prior to the end of the fund life. The most common type of secondary deal is known as a limited-partner transaction. A fund investor sells an interest, or a portfolio of interests, to another investor (a purchasing investor) based on a negotiated price, usually as a percentage of net asset value (NAV). The purchasing investor assumes the legal and financial obligations to the underlying fund(s).

Sellers are usually motivated to undertake these transactions for the following three reasons: active portfolio management, strategic and regulatory drivers or liquidity-driven situations. Over the past several years, for example, large pension and sovereign-wealth funds have begun to use a more liquid secondary market in order to re-balance exposures and reduce the number of private-equity relationships – effectively adopting traditional-asset-management techniques to managing their illiquid PE portfolios. Using the secondaries market has also become more economically attractive to sellers as the discount to NAV has narrowed in recent years and prices paid (on average) have increased.

Limited-partnership sales accounted for around three quarters of transaction volumes in 2017 (see chart). The growth in secondaries really started during the global financial crisis ten years ago. Increased scrutiny and regulation of large financial institutions and banks led to strategic portfolio sales of illiquid and directly held private-equity assets and underlying private-equity-fund commitments. While this part of the market has historically generated attractive opportunities, its prevalence has waned in recent years as banks have reduced their balance sheets and exposure to private assets. Liquidity-driven or distressed situations can also still occur today, but have historically been less common.

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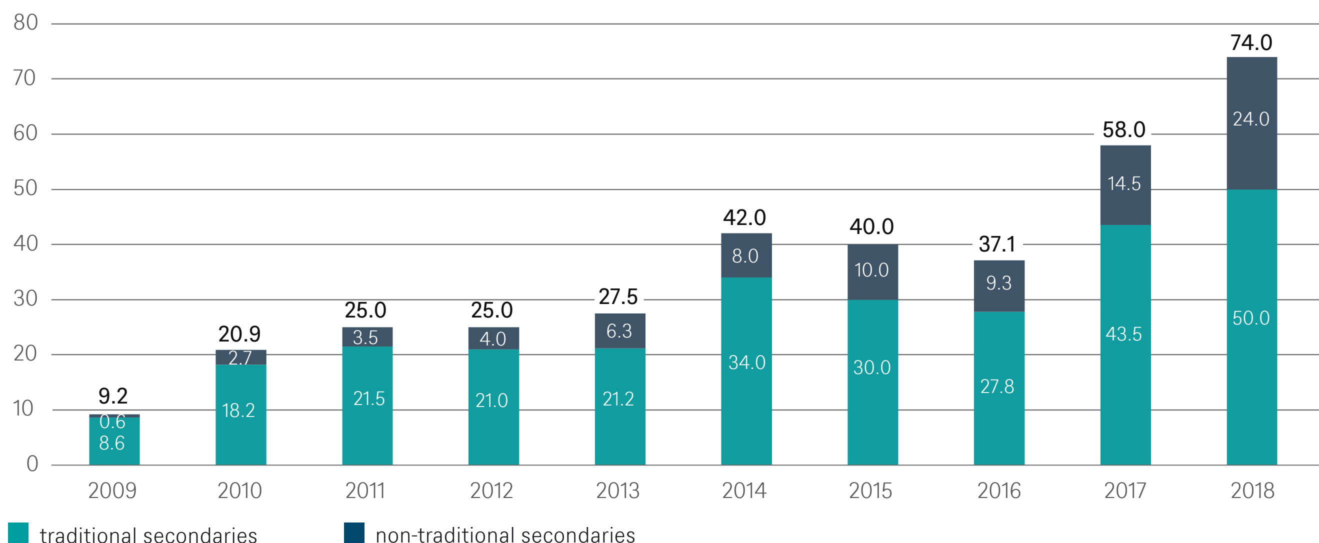
SECONDARY MARKET VOLUME REMAINS AT RECORD LEVELS

In recent decades, the secondary market has grown rapidly, with volumes increasing from $9 billion in 2009 to $74 billion in 2018.



Sources: Greenhill & Co., Inc. as of 01/2017; Greenhill & Co., Inc. as of 01/2019; DWS Investment GmbH as of 6/13/19

Another, increasingly common type of secondaries are manager-led transactions. Managers – called general partners (GPs) – might seek liquidity options on behalf of investors for the remaining assets in a fund, while also potentially securing additional time (and sometimes capital) for a portfolio of legacy assets to mature and be primed for sale (usually called an "exit"). The structuring (or re-structuring) of these types of transactions can be complex and time consuming. Usually, it requires highly bespoke solutions around the composition of the underlying portfolio, the price to sellers and the alignment between old and new investors, as well as the manager. GP-led deals and other non-traditional secondary transactions such as preferred-equity purchases, already account for between a quarter and a third of deal volume (see chart) and we believe such deals may play an increasingly important role in the future.

Effectively, growth in the secondary market has contributed to somewhat greater liquidity in the PE asset class. The secondary market offers investors (in secondaries funds) instant access to a highly diversified private-equity portfolio; providing exposure across vintage years, sectors and geographies – while sellers benefit from an active buyer universe for their illiquid PE positions. However, the secondary market still remains much smaller than the primary market: less than 2% of private-equity assets are estimated to trade hands each year. Its rapid growth reflects structural changes in the market.

Traditionally there has been a trade-off when investing via the secondary market. Historically, cash returns have tended to be lower because of less risk (usually due to a high level of diversification), shorter holding periods, reduced scope for valuation anomalies and the fact that often secondaries sales are of portfolios that include assets of varying quality. In buying a whole fund position, you get the good with the bad.

However, we believe there may be ways to get the best of both direct and secondary investing. By focusing on "stock-picking" later-stage investments within an existing PE-fund portfolio, new investors may be able to collaborate with a fund manager's (GP's) best portfolio companies.

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Supporting these companies can ideally satisfy every stakeholder: new investor, incumbent investors, GPs, as well as the underlying portfolio companies. It may also result in higher returns relative to the market, not least by maintaining the key tenets of a secondary transaction (shorter duration, earlier distributions) while tactically identifying individual, attractive assets within an existing PE-fund portfolio.

A partnership approach is not without risks, however. The market for secondaries has experienced record fundraising, with dry powder now at 2.6 times the supply of deal flow, more than double what it was six years ago. As a result, the market has become far more competitive, making returns harder to generate, particularly for more "traditional" secondaries specialists.

A strong historical correlation between public-market volatility and growth and pricing in the traditional secondaries market, investors looking for entry points will likely face similar dynamics to public markets. As long as listed-equity markets continue to rise and a solid macroeconomic backdrop prevails, it could contribute to more optimistic underwritings at the asset level, thereby validating current pricing levels. A wide-spread downturn, though, triggered, for example, by escalating trade tensions, would no doubt also be felt in PE generally, and in the market for secondaries in particular. On the positive side, it may also create new, attractive opportunities, especially for tactical strategies as outlined previously.

GLOSSARY

A balance sheet summarizes a company's assets, liabilities and shareholder equity.

Correlation is a measure of how closely two variables move together over time.

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

Dry powder, in a private-equity context, refers to cash or other very liquid reserves that can easily be deployed for investment.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond’s sensitivity towards interest-rate changes.

The financial crisis refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

In a private-equity context, general partners (GPs) refer to the managing partners in a private-equity firm who make the investment decisions.

Limited partnerships (LPs) are a form of partnership where one or more partners has only limited liability and no management authority. Private equity operations often exist in this form.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

Net asset value (NAV) is the value of an organisation's assets minus the value of its liabilities.

Private equity (PE) is a direct or indirect investment by a financial investor in a substantial part of a company's equity. Usually the company invested in is not listed.

On the secondary market, securities or assets are purchased from other investors, rather than from issuing companies themselves.

A private-equity fund’s "Vintage" generally refers to the year when the fund closes or starts investing.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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