MEKETA
INVESTMENT GROUP

Secondary Market

RESEARCH NOTE
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Thirty years ago, if Limited Partners wanted to sell their interest in a private equity fund, they would have to deal with a range of obstacles, including a General Partner potentially unwilling to allow the transfer, a cumbersome legal transfer process, double digit discounts to stated value, few buyers, few intermediaries, and no real market, among other factors. Today, these so-called "secondary" transactions occur within a well-functioning market with a myriad of institutional participants and, for private equity funds, that totaled over $65 billion annually.

Introduction

From its beginnings in the early 1980's, the secondary market has grown substantially with an expanding range of transaction types, dedicated investment funds, buyers focused on specific verticals (e.g., energy, venture, real estate), and a growing set of intermediaries. As a result, the transaction "friction" has decreased. Several secondary market purchasers have seen attractive returns on their investment, thereby driving capital to the asset class. In today's market, owners of private market funds have a greater ability to make changes to their investment portfolio to meet their strategic needs. Additionally, General Partners have increasingly used the secondary market to allow investors to achieve early liquidity, even in well-performing portfolios.

Definition

The private investments secondary market (also often called "secondaries") refers to the buying and selling of pre-existing investor commitments to private market and other closed end alternative investment funds. By its nature, the private market asset class is illiquid, and intended to be a long-term investment for buy-and-hold investors. For the vast majority of private market investments, there is no listed public market. Given the absence of established trading markets for these interests, the transfer of interests in private market funds is complex and labor-intensive.

As shown in the following schematic, a secondary market transaction involves the sale of the Limited Partner's ("LP") interest in a fund to the Secondary Buyer (often another LP or a Secondary Fund Manager). The LP sells not only the value of the interest, but also transfers the liability for any unfunded capital to the Secondary Buyer. All transactions require the consent of the General Partner.

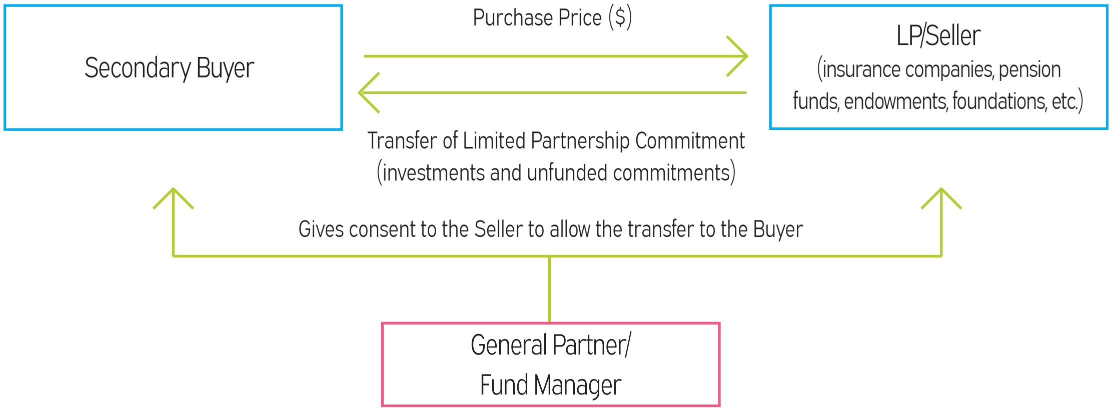

FIGURE 1

Secondary market transactions tend to occur between the 2nd and 8th year of a private market fund's life. During this period, the General Partner has deployed some or all of the fund's capital in portfolio companies and is seeking to increase their value. As such, the Secondary Buyer is able to "see" the portfolio and make its own assessment of the ultimate value and timing of exits.

Current market

The value of secondary market transactions has increased significantly in recent years, with 2018 marking the highest level to date, as more Secondary Fund Managers have dedicated resources and capital to purchasing these interests.

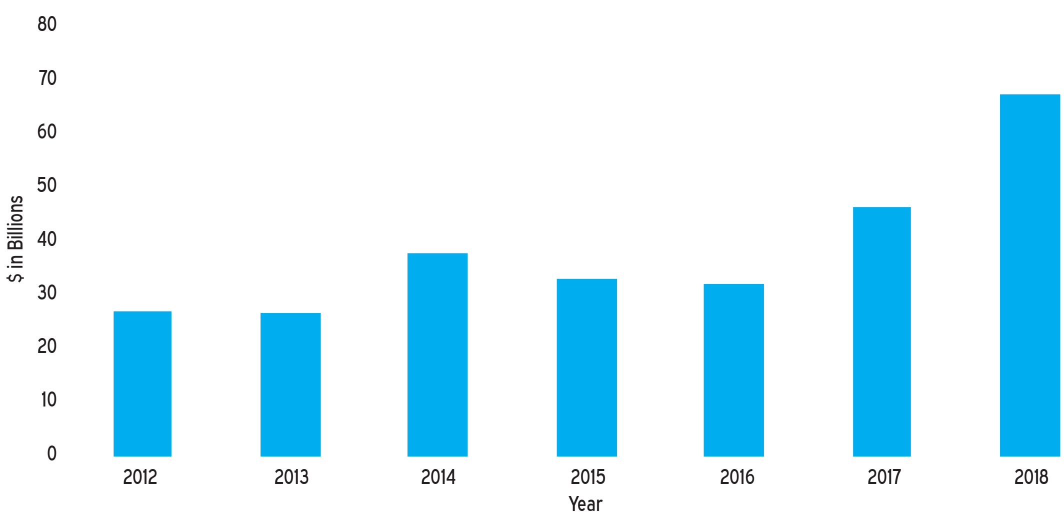

FIGURE 2
Total Private Equity Secondary Transaction Volume

Source: UBS

In private equity, the secondary market is led by transactions involving buyout funds, with venture capital and growth equity funds representing a smaller share. Given that buyout investments typically involve companies with established businesses, meaningful revenue and cash flow, the Secondary Buyer has better information with which to assess the value of the portfolio companies and hence the value of the LP interest.

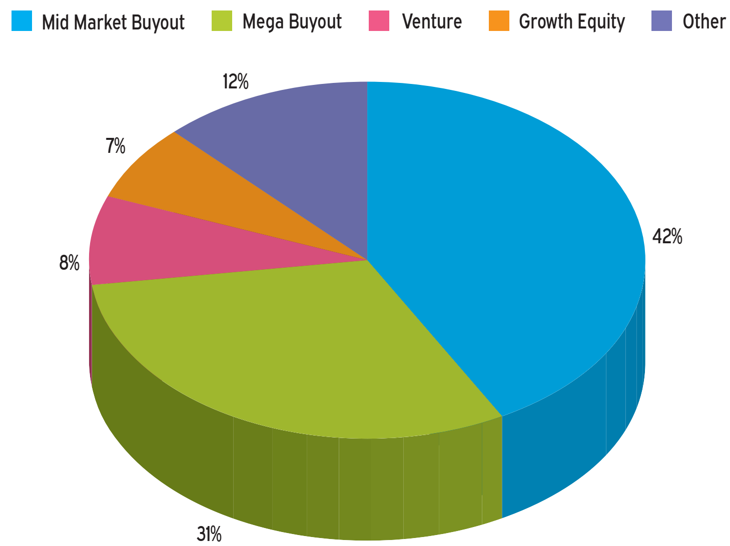

FIGURE 3
2018 Transaction Volume by Strategy

Source: UBS

Secondary transaction pricing

Secondary Buyers bid on an LP interest based on the Net Asset Value ("NAV") of the Seller's position in the fund. The NAV is most often reported in the LP's Capital Account Statement, which states the LP's pro rata share of the value in the fund. Secondary Buyers quote their prices in relation to the fund's NAV, and often at a discount. The level of discount reflects the Secondary Buyer's target return.

As a result of the increase in capital available for secondary transactions as well as more efficient "price discovery" in the market, Secondary Buyer target returns (expressed as a multiple of purchase price) have declined steadily in recent years. As shown in Chart 3 on the following page, in 2018, 63% of surveyed Secondary Buyers were seeking returns of 1.3x-1.5x, compared to only 26% of Secondary Buyers in 2014. By contrast, in 2014, 21% of Secondary Buyers were seeking 1.7x-1.9x returns, while only 4% were underwriting to that level in 2018.

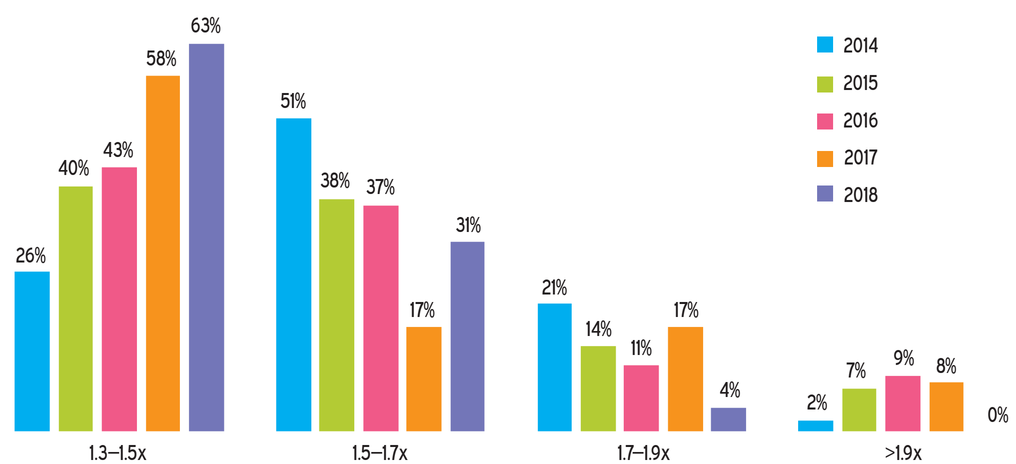

FIGURE 4
Secondary Buyer Target Returns[1]

[1] Diversified portfolio of buyout funds.
Source: Evercore.

Recent developments

As the secondary market continues to grow, several trends have emerged in recent years.

→ **Increasing participation by public pensions** Public pensions have increasingly utilized the secondary market to "rebalance" their portfolios. Through the early 2000s, the secondary market was led by sellers that were strongly motivated to reduce their illiquid portfolio—whether due to internal stress, liquidity needs, or a change in investment strategy. Often this resulted in sellers accepting relatively large discounts to NAV. Also, the transaction volume was relatively low, making it difficult for larger sellers to efficiently sell portfolios greater than a couple hundred million of NAV. Over time, the size and range of transaction types in the secondary market, as well as generally strong pricing, have made secondary sales a potentially attractive option for public pension funds.

→ **Rise of the "mega" Secondary Buyer** Funds dedicated to purchasing secondary market investments have become some of the largest capital pools in private markets. These include Ardian and Lexington Capital, which are seeking $18 billion and $12 billion for their current secondary funds, respectively. These "mega" secondary managers have large and sophisticated investment staff and a global footprint.

Overall, there is a marked decline in the historical stigma attached to secondary transactions.

→ **Increasing use of leverage** Secondary Buyers develop detailed estimates of how the fund interest they are purchasing will ultimately develop liquidity. These models are developed so the Secondary Buyer can estimate how a whole portfolio of investments may generate cash. Secondary Buyers can utilize these insights into cash flow dynamics to strategically leverage their portfolio. As a result, the Secondary Buyer can improve its returns as well as extend its capital to purchase more interests. From 2017 to 2018, portfolio leverage has increased from 20% to 40% of all special purpose vehicles ("SPVs") to acquire secondary portfolios.[2]

[2] Source: Campbell Lutyens

- **General Partner-led buyouts** Historically, a General Partner-led secondary transaction was used to help liquidate a poorly performing portfolio that had limited opportunities for near-term success and/or the Limited Partners had lost faith in the General Partner. In recent years, there has been an increasing trend for General Partners of healthy portfolios to use the secondary market to help provide liquidity to their Limited Partners. The key issues in General Partner-led transactions include a clear description of the transaction rationale, transparency in the process, multiple options for the Limited Partner, and alignment of interests among the parties.

Conclusions

The secondary market continues to grow and develop. Transaction volumes are expected to continue to rise, leading to more efficient price discovery between buyers and sellers. Some Secondary Buyers are choosing to focus on specific verticals in the secondary market (e.g., energy, infrastructure, real estate), which allow them to more effectively underwrite the specific risks of these funds. Market participants are continuing to develop new and innovative structures to reflect the specific needs of sellers, buyers, and General Partners. Overall, there is a marked decline in the historical stigma attached to secondary transactions.

The secondary market provides a broader opportunity set for Limited Partners to shape their portfolio, even after they make a fund commitment. As part of the development of the secondary market, Limited Partners should expect a rise in requests from General Partners to consider participating in transactions they are leading. These transactions require the Limited Partner to carefully scrutinize its options as no one transaction is exactly like another.

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