MEKETA

Limited Partner (LP) Secondary Markets

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Secondary markets have evolved from being a virtual wild west for private market investors into a full-fledged market that provides flexibility for both building and trimming private market portfolios. In this paper, we focus on Limited Partner ("LP") secondaries.[1] We review the nature of secondary market transactions and how pricing works in this otherwise illiquid marketplace. We discuss the evolution of secondary markets and the current opportunity set. We evaluate historical performance, and address what we believe are the primary pros and cons.

1 For more information about GP-led secondaries, readers can see Meketa's paper on the topic..

Key takeaways

- The secondary market has grown substantially over the last twenty years with transaction volume having more than doubled since 2015.
- The LP secondary market no longer carries the stigma it once did, as there is no longer a perception that most sellers are desperate or that the assets available for sale represent the dregs of an investor's portfolio.
- The LP secondary market has produced relatively attractive historical returns that are in line with the private equity buyouts strategy on an IRR basis.
- The secondary market has become more efficient over time, with investors targeting lower returns (i.e., willing to pay higher prices) during normal market conditions.

What are secondaries?

The private investments secondary market for LPs, also known as "LP secondaries," refers to the buying and selling of pre-existing investor commitments to private market funds. It represents a LP, or an investor who has committed capital to the fund, selling their interest in a fund to another investor.[2]

By its nature, the private market asset class is illiquid and intended to be a long-term investment. For the vast majority of private market investments, there is no public exchange on which they can be traded. Given the absence of established trading markets for these interests, the transfer of interests in private market funds is complex and labor-intensive. The secondaries market serves as an informal marketplace for the transfer of these interests.

2 Note that roughly half of the secondary market volume since 2020 has been in the form of GP-led transactions. GP-led secondaries are initiated by the GP, often to restructure the ownership of one or more assets within their funds while providing a liquidity option to existing LPs. The vast majority involve creating a new vehicle, called a "continuation fund," that purchases one or more companies from the GP's existing fund(s). The continuation fund is managed by the same GP and backed by new investors plus any existing LPs that wish to retain exposure to the asset(s).

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Figure 1 depicts a diagram of how a secondary market transaction may occur. The sale process normally begins with the LP approaching potential buyers, often through intermediaries such as specialized investment banks. LPs typically offer multiple funds for sale. Transactions are typically structured so that potential buyers, which are often other LPs or secondary fund managers, may bid on some or all of the LP's positions that have been made available for sale. The seller (i.e., the current LP) works with the buyer(s) to negotiate a price for the positions in which they are interested and agree to terms. Once the terms are agreed upon, the LP must typically seek and receive consent from the General Partner ("GP") of each fund to transfer their interest in the fund to the new buyer. After this approval is received, the LP sells their interest and transfers the assets, as well as the liability for any unfunded capital calls, to the buyer. In so doing, the secondary buyer becomes responsible for any future capital calls. This results in the buyer becoming the new LP. Transferring an LP's interest in a fund to a "new" LP should not impact the overall fund, as the other LPs, the underlying investments, and the fund terms remain the same.

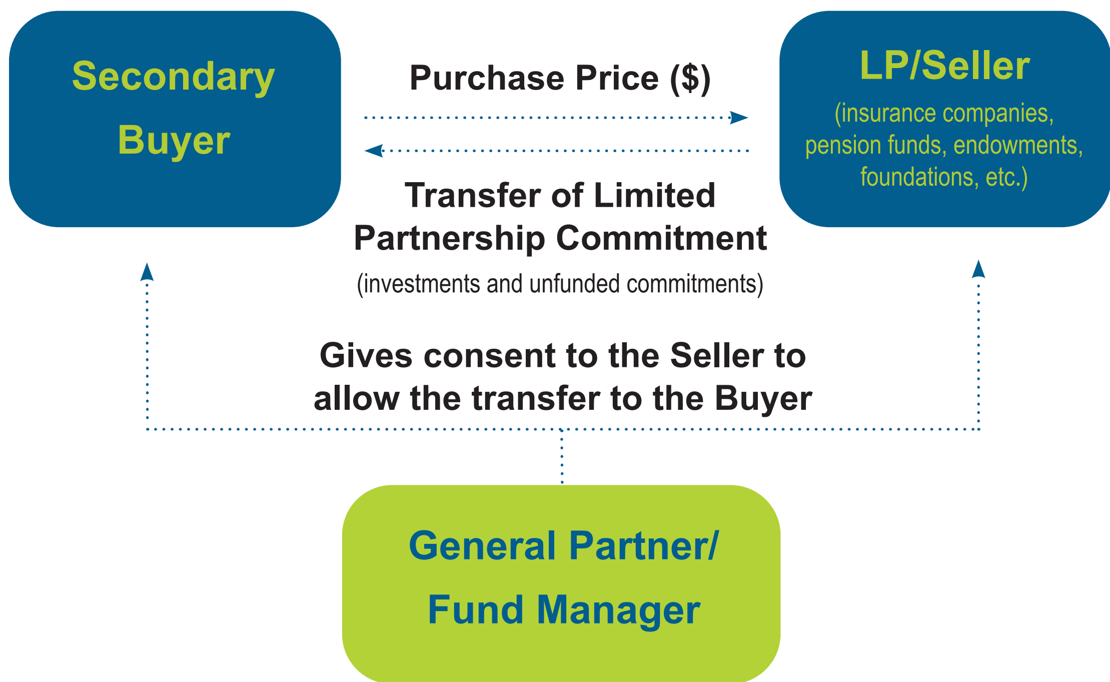

FIGURE 1
Secondary Market Diagram

Source: Meketa Investment Group, 2024.

Secondary market transactions tend to occur after a substantial portion of the fund's assets have been invested. However, any year in the life of a fund may be targeted, and some managers may even target specific time periods. For example, a manager may target the end stages of a fund's life and seek secondary market transactions after year ten. The reason many secondary transactions typically occur later in a fund's life is that the GP has deployed most 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 investments in the portfolio and make their own informed assessment of the ultimate value and timing of exits in the portfolio.

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The evolution of the secondary market

The secondaries market first became notable in the early 1980s. From its beginning through the late 1990s and early 2000s, the secondary market was largely driven by LPs seeking to sell their positions as they were compelled to generate liquidity, which often caused them to exit their fund investments prematurely. In these early days, the assumption that most secondary sales were being done by forced sellers led to a generally negative opinion being associated with secondary transactions. However, the secondary market began to grow after the dot-com bubble burst in the early 2000s and certain private equity investors became exposed to significant liquidity squeezes. Secondary market growth accelerated as a result of the Global Financial Crisis ("GFC") when many investors were compelled to sell for liquidity or regulatory reasons. The secondary market has since grown substantially (see Figure 2), paralleling the expansion in the traditional private equity market, thereby allowing many LPs to use the secondary market to restructure their private markets portfolios for strategic reasons. There have been notable spikes in aggregate capital raised in 2009, 2020 and, most recently, in 2023 corresponding to capital raises from the largest secondaries fund managers. Several large secondaries funds in recent years have raised $15 billion to $25 billion each. The secondaries market's growth has also expanded the secondary market's range of transaction types, increased the dedicated number of investment funds and their capital, and prompted a growing set of intermediaries within the space.

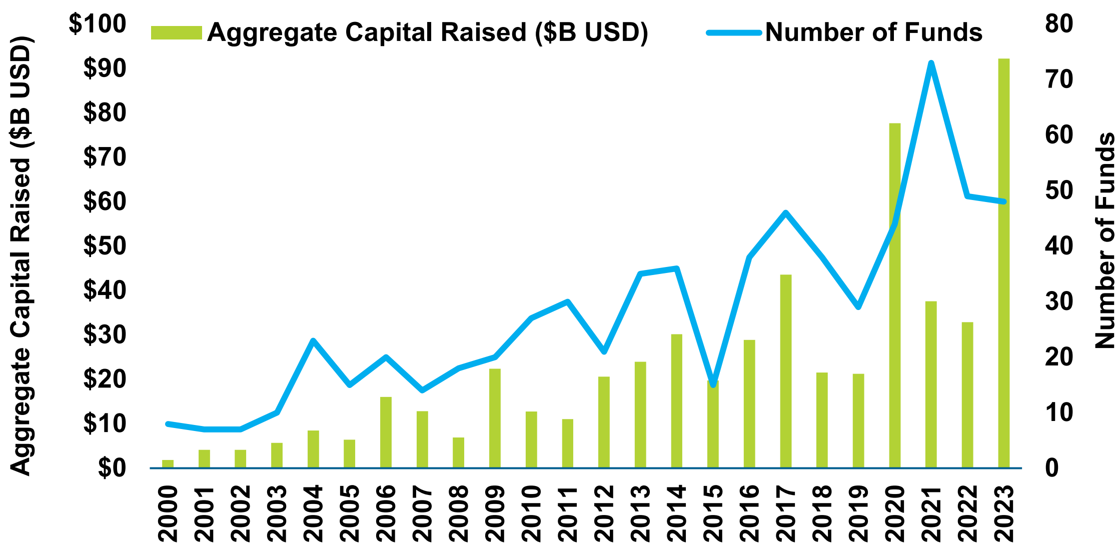

FIGURE 2
Historical Fundraising in the Global Private Equity Secondaries Market

Source: Preqin, as of December 31, 2023. Data pulled on August 8, 2024.

In support of (or perhaps due in part to) the market growth over the past two decades, the transaction friction and stigma associated with secondaries has greatly decreased. This is largely due to secondaries becoming a more commonly accepted way for sellers to rebalance portfolios and exit out of noncore positions. Additionally, an established history of relatively attractive returns for secondary market purchasers has helped to promote secondary transactions as a viable option for investors. While there may still be some "forced sellers," they now represent a much smaller portion of the secondary market. It is now quite common for investors

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to engage in secondary sales for reasons other than liquidity needs. This may include restructuring their portfolio to meet strategic needs, such as a rebalancing toward their target allocation, reducing exposure in areas they no longer find compelling, or consolidating the number of GPs on their roster.

Secondary market universe

The value of secondary market transactions has increased significantly over the past decade, partly due to a greater number of secondary fund managers. Figure 3 shows how annual aggregate secondary market volume has more than doubled from 2015 to 2023 and more than tripled from 2015 to its peak in 2021.

Figure 3 also shows market transaction volume by LP- and GP-led secondaries. As seen in blue in the chart, LP-led secondaries have been steadily increasing in value (with the exception of the COVID pandemic year), nearly doubling from 2015 to 2023. Over the past several years, LP-led transaction volume has remained fairly constant at around $60 billion. GP-led secondaries,[3] on the other hand, involve the sale of one or more assets from an old fund to a new vehicle, which the existing GP continues to manage. As seen in green in the chart, GP-led secondaries have experienced even more dramatic growth over the past nine years, increasing by over 5x since 2015.

[3] An analysis of GP-Led Secondaries is outside the scope of this paper, see Meketa's GP-Led Secondaries Whitepaper for more information.

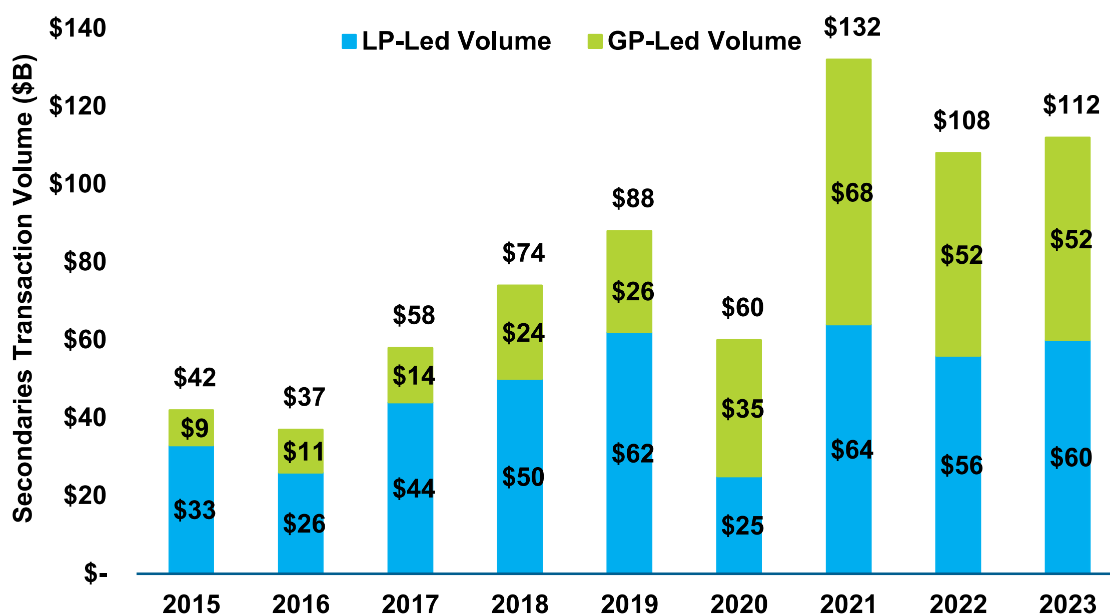

FIGURE 3
Total Secondary Market Annual Transaction Volume

Source: Jefferies, Global Secondary Market Review, January 2024. Note that years 2015 and 2016 data comes from Jefferies' prior years' reports.

In comparison to the traditional private market universe (particularly private equity), the secondary market is relatively small.[4] This is because only around 3% to 5% of outstanding LP exposure (i.e., NAV plus unfunded commitments) comes to market each year. Historically, less than 2% of outstanding LP exposure is actually traded each year.

[4] Private Equity aggregate transaction volume was $1.18T in 2021, $726B in 2022, and $474B in 2023. Source: S&P Global, "Global private equity deal activity plunges in 2023," January 16, 2024.

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Secondary market composition

Private equity accounts for the vast majority of secondary transaction volume. In 2023, private equity represented 83% of transaction volume, followed by infrastructure and real assets at 8%, private debt at 4%, real estate at 2%, and other strategies representing 3%.[5] Specifically, buyout funds represented the bulk of private equity secondary transactions at 75% (see Figure 4). One reason for buyout's dominance is that buyout investments typically involve companies with established businesses and meaningful revenue and cash flow, thus giving the secondary buyer better information to assess the portfolio companies' value and hence the value of the LP interest. While most secondary market transactions are for interests in buyout funds, some secondary buyers focus on specific asset classes or sectors, which may allow for more effective underwriting of specific risks. The growth in these markets has been driven by specialist managers who bring greater expertise in valuing the underlying assets.

[5] Source: Greenhill, Global Secondary Market Review, Full Year 2023.

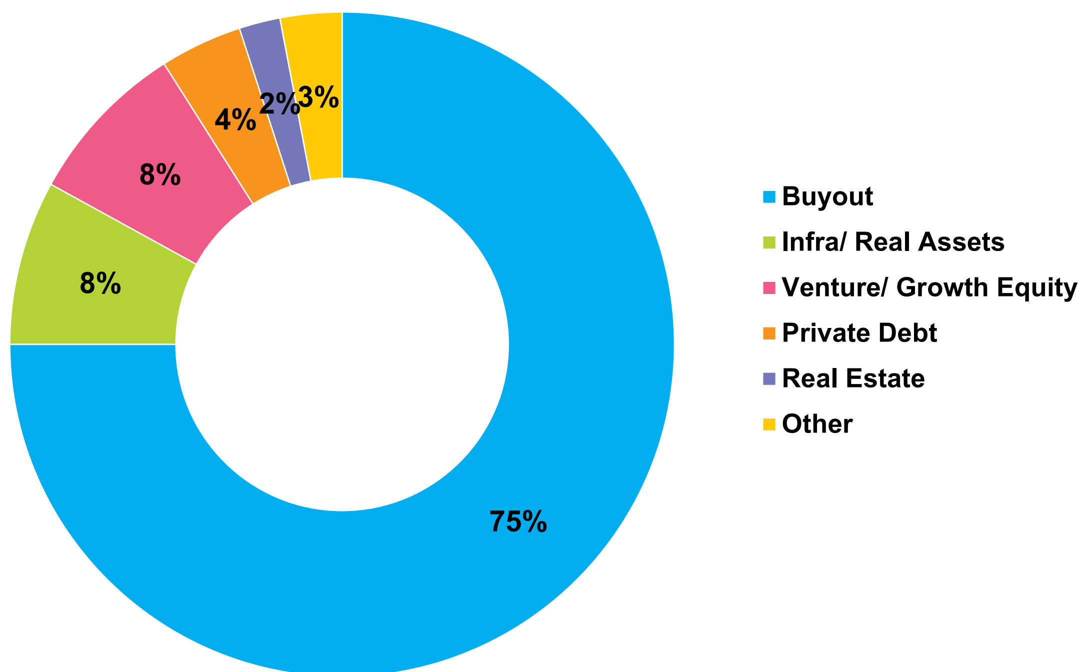

FIGURE 4
2023 Transaction Volume by Strategy

Source: Greenhill, Global Secondary Market Review, Full Year 2023.

Current market conditions

The capital available for secondary market transactions tends to range from 2x to 3x of the amount of annual secondary transaction volume, consistent with that of traditional buyout funds. The COVID pandemic slowed secondary (and many other private market) transactions, causing the capital available for secondary market transactions to increase to over 3x annual transaction volume in 2020. While available secondary capital increased in 2021, volume did as well, thereby bringing secondary capital overhang back to within historic norms (see Figure 5).[6] This rebalancing is likely contributing to the recent moderation of secondary pricing.

[6] Capital overhang refers to the amount of capital that has been committed to a particular asset class but has not yet been invested.

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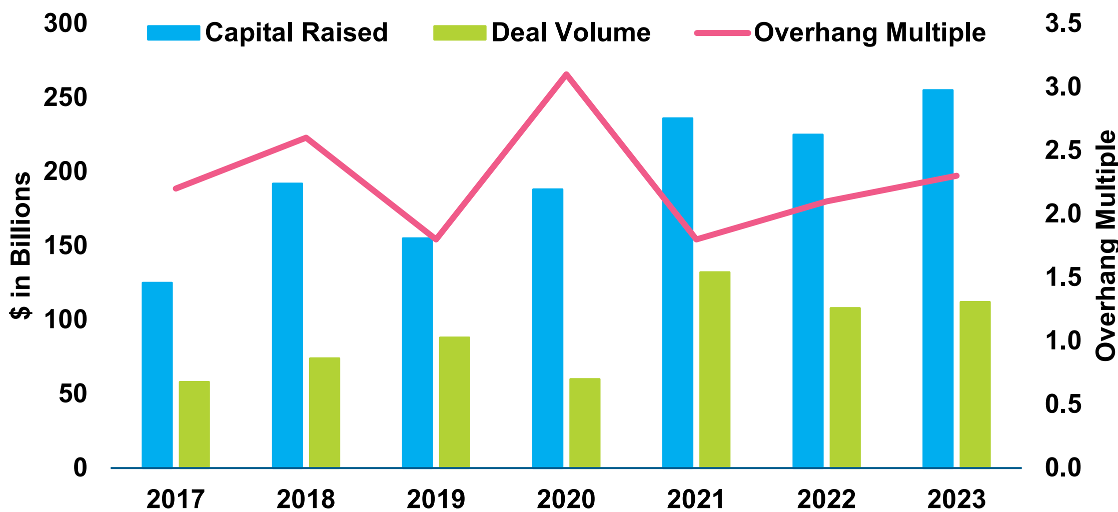

FIGURE 5
Secondary Capital Overhang

Source: Jefferies, Global Secondary Market Review, January 2024. Note that the deal volume shown includes GP-led secondaries. The overhang multiple reflects the ratio of unfunded capital in dedicated secondary funds to secondary transaction volume over the prior year.

Secondary market pricing

Secondary buyers bid on an LP's 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 and 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 and takes into account market conditions as well as idiosyncratic factors. In practice, LPs often offer interests in a group of multiple funds for sale, allowing secondary buyers to choose to bid on the whole group or individual funds. In these types of transactions, the relative discount to NAV (if any) can vary for each fund.

As shown in Figure 6 below, buyouts tend to have the smallest discounts (i.e., they transact at the highest percent of NAV), while venture capital typically commands the steepest discounts (i.e., they transact at a lower percent of NAV).

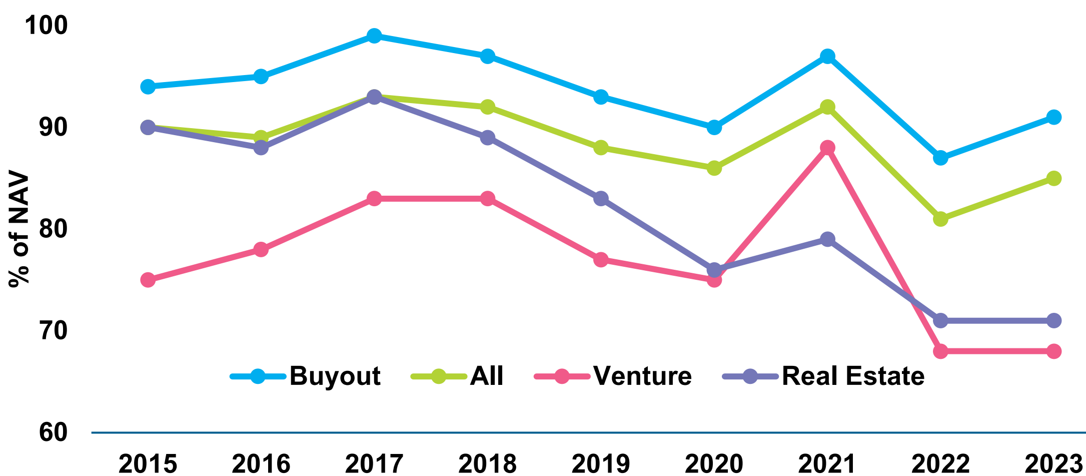

FIGURE 6
Secondary Pricing by Strategy

Source: Jefferies, Global Secondary Market Review, January 2024. "All" refers to the aggregate of all private markets' strategies included in the vendor's composite.

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The price offered by a potential buyer reflects their target risk and return. Pricing offered in the secondary market tends to vary based on both the economic and secondary market environment. However, target returns for buyers have gradually declined over time. One reason for the decline is that it partly reflects a natural maturity of the secondaries market from its early days when secondaries were often perceived as distressed sales, to its evolution over the last two decades into an attractive strategy in its own right. Other reasons for the decline in target returns is that it reflects the natural side effect of a greater amount of capital and volume in the secondaries market, as well as more efficient "price discovery."[7] However, Figure 7 below shows that there has been a general increase in targeted returns from 2020 to 2023. This may be due to a number of external factors, such as COVID-19 recovery as well as rate hikes from the Federal Reserve, though it is too early to tell at this time if this trend will persist within the secondaries environment.

[7] Price discovery refers to the process of determining the prices of assets in a marketplace though the interactions of buyers and sellers. Definition source: NASDAQ."

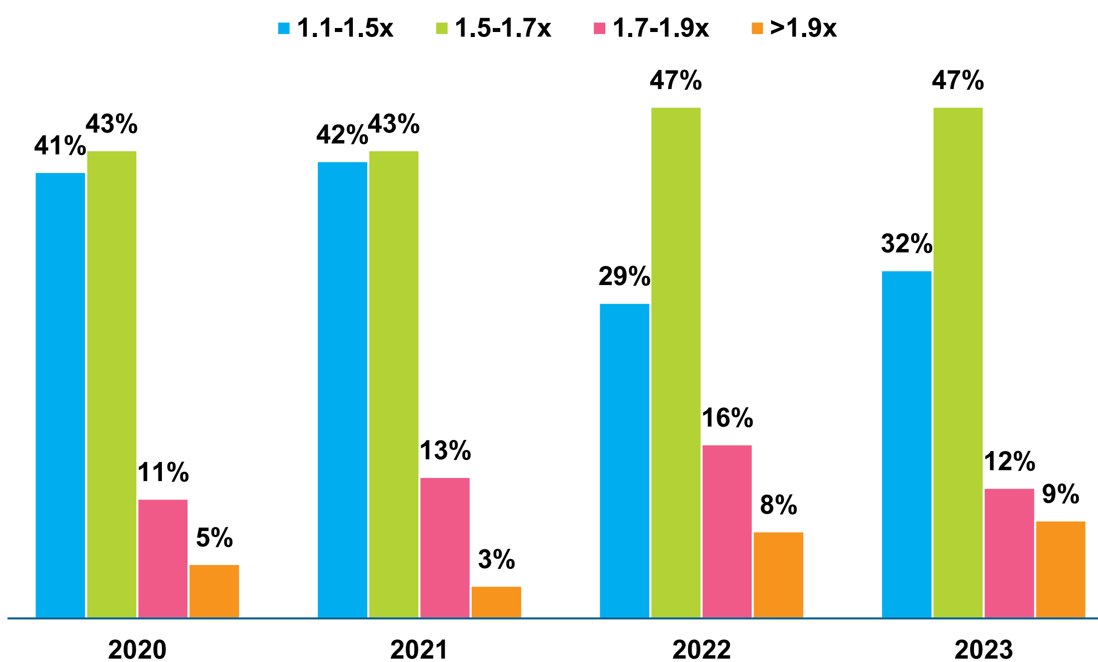

FIGURE 7

Secondary Buyer Target Returns

Source: Evercore, FY 2023 Secondary Market Survey Results. Reflects a diversified portfolio of LP positions. Note values may not add to 100% due to rounding.

How has the secondary market performed?

The performance of secondary funds tends to resemble that of the US buyout universe from year to year (see Figure 8). Secondaries have produced average IRRs slightly below those of buyouts over the long term. Over the trailing twenty years, US secondaries produced a 13.6% average annualized IRR, modestly trailing the 15.2% IRR of US buyouts.[8] This relationship has held true over the more recent ten-year period, with US secondaries producing an annualized IRR of 12.5% and US buyouts producing 15.5%. Secondaries appear to have produced their best relative returns during periods that followed significant market stress (e.g., the dot-com bubble and GFC), when secondary buyers were generally able to purchase interests at a steeper than usual discount.

[8] Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries. Returns are net of fees.

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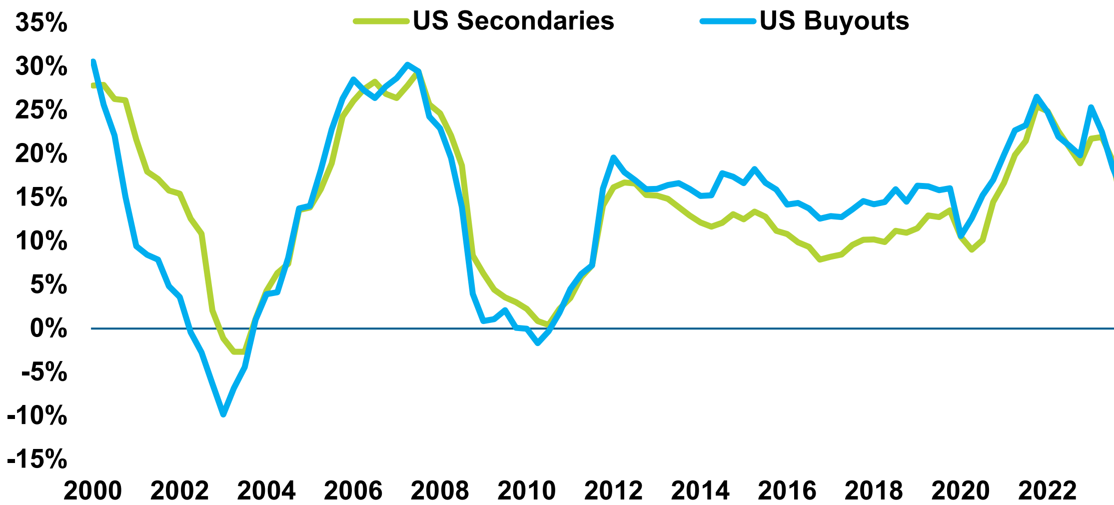

FIGURE 8

Rolling 3-Year Annualized IRR

Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries. Returns are net of fees.

While secondaries have produced historically attractive IRRs that have been in line with buyouts, they have not produced as attractive TVPIs. IRR, or the Internal Rate of Return, is the discount rate that makes the net present value ("NPV") off all cash flows equal to zero. In other words, it shows the annualized rate of return, accounting for both the timing and size of cash flows (i.e., capital calls and distributions). The higher the IRR, the higher the return on the investment. TVPI, or Total Value Paid In, is another performance metric that considers the full value of cash flows into (and out of) the fund. However, the key difference between IRR and TVPI is that TVPI does not account for the timing of cash flows. Thus, TVPI does not reflect the speed at which a fund generates returns.

Since vintage year 2002, TVPIs for US secondaries have averaged 1.5x, below US buyout's 1.9x (see Figure 9).[9] This may imply that while secondaries have attractive IRRs, especially in their early years as assets purchased are often quickly marked to par, they may have less attractive TVPIs over the full life of the investment.

9 Source: Cambridge Associates via IHS Markit, annual pooled TVPI as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries. Returns are net of fees. Vintage years 2022 and 2023 are excluded as they are too recent to be meaningful in this analysis.

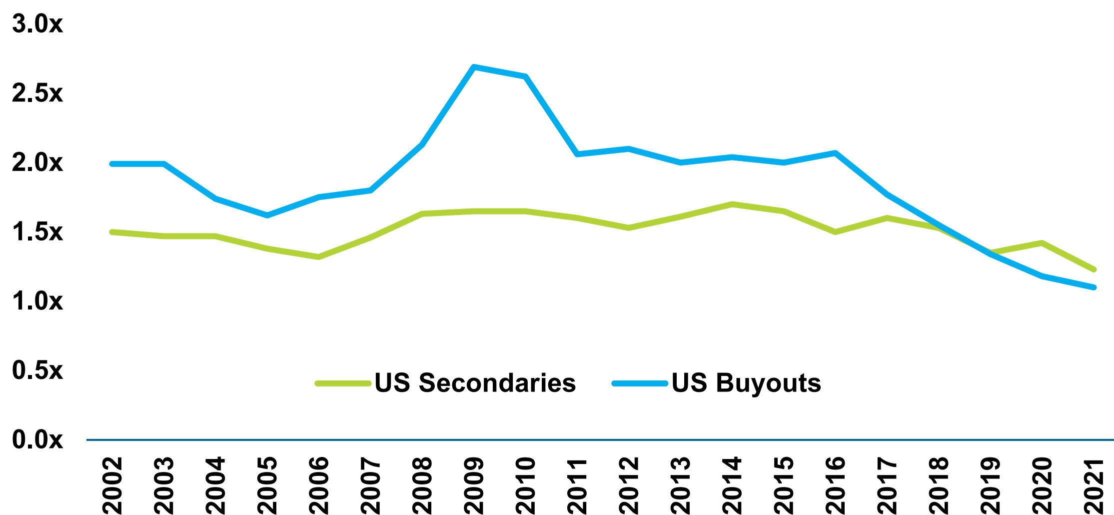

FIGURE 9

Vintage Year-Since Inception Pooled TVPI

Source: Cambridge Associates via IHS Markit, annual pooled TVPI as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries. Returns are net of fees. Vintage years 2022 and 2023 are excluded as they are too recent to be meaningful in this analysis.

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DPI, or Distributions to Paid In, is another metric used to evaluate fund performance. It measures a fund's total distributions as a multiple of the total capital that has been paid into the fund. Unlike TVPI, which looks at both realized and unrealized returns, DPI measures only realized returns. Therefore, when a fund reaches its liquidation, TVPI should equal DPI. Since secondary funds are often purchasing mature assets/stakes, they tend to be quicker to return capital than traditional buyout funds, resulting in higher DPIs. As shown in Figure 10 below, US secondary funds with vintage years of 2017 to 2020 (approximately four to seven years into their fund term), have higher pooled DPIs than US buyouts of the same age. It is not until funds become substantially more realized (around year 10) that buyouts exhibit a clear edge in DPI.

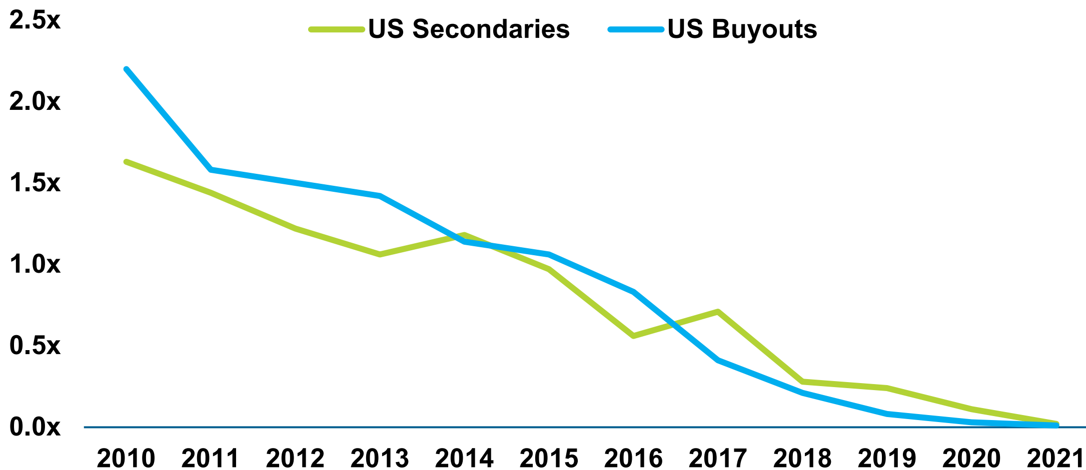

FIGURE 10

Vintage Year-Since Inception Pooled DPI

Source: Cambridge Associates via IHS Markit, annual pooled DPI as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries. Returns are net of fees. Vintage years 2022 and 2023 are excluded as they are too recent to be meaningful in this analysis.

Volatility

US secondaries have exhibited similar volatility levels compared to US buyouts (see Figure 11). Over the trailing twenty years, US secondaries had an annualized volatility of 8.9%, slightly lower than US buyouts' 9.6%.[10] This has not changed significantly over the past ten years, with US secondaries and US buyouts' annualized volatility at 8.3% and 8.1%, respectively.

[10] Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries.

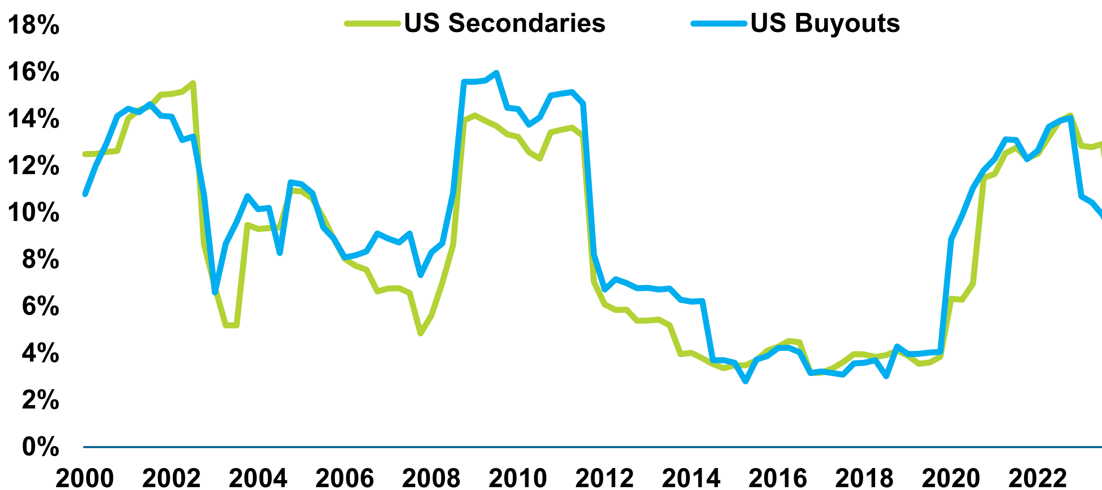

FIGURE 11

Rolling 3-Year Volatility

Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries.

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Manager alpha

Interquartile spreads, or the potential value from selecting superior active managers/funds, has (on average) been lower for US secondaries compared to US buyouts in the last decade. Over the trailing ten years, US secondaries have had an average annual interquartile spread of 12.1% while US buyouts have had a higher annual spread at 13.4%.[11] This shows that manager/fund selection matters in both spaces.

[11] Source: Cambridge Associates via IHS Markit, annual Pooled IRR quartiles by vintage year as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries. Vintage years 2022 and 2023 are excluded as they are too recent to be meaningful in this analysis. Returns are net of fees. Note that some of the difference in performance may be because US Secondary funds have a smaller average annual fund count at 12, compared to US buyouts' 43.

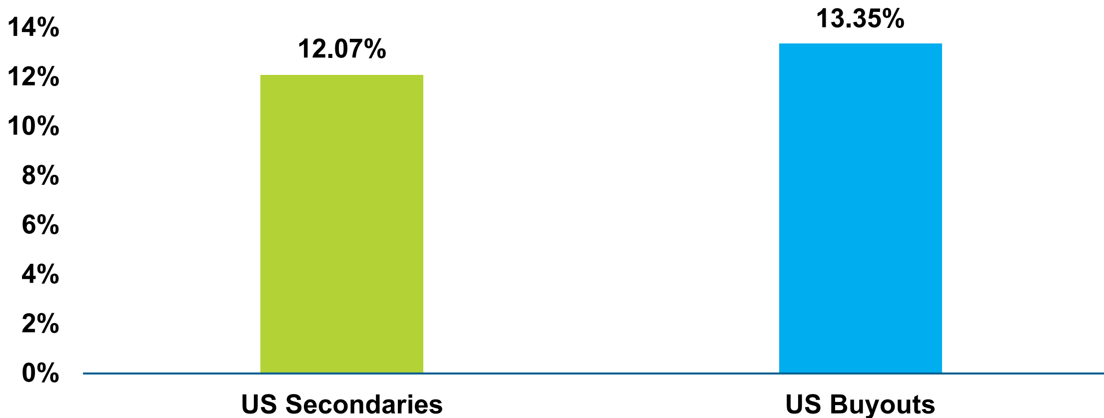

FIGURE 12
Trailing 10-Year Interquartile Spread

Source: Cambridge Associates via IHS Markit, annual Pooled IRR quartiles by vintage year as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries. Vintage years 2022 and 2023 are excluded as they are too recent to be meaningful in this analysis. Returns are net of fees.

Because US secondaries and US buyouts have exhibited such close interquartile spreads over the past ten years, it may be beneficial to take a closer look at this relationship. Figure 13 shows that US buyouts have had higher interquartile spreads in roughly two-thirds of the vintage years analyzed below. Though in the vintage years where US secondaries did have greater interquartile spreads, they tended to be at a greater magnitude. Note that some of this relationship may be skewed due to US secondaries' lower average fund count compared to US buyouts.[12]

[12] Since 2003, US secondaries had an average fund count of 11 while US buyouts had an average fund count of 41.

US buyouts' higher trailing 10-year average interquartile spread, coupled with their higher spread in the majority of vintage years over the past two decades, may imply that traditional buyout funds offer more alpha potential than the secondary market. However, it also implies that secondaries may offer substantially increased manager alpha potential compared to many public markets' asset classes.[13]

[13] See Meketa's "In Search of Manager Alpha" white paper for a comparison to public markets. For example, the analysis in that paper shows that interquartile spreads for large cap US equities have averaged 6.3% historically.

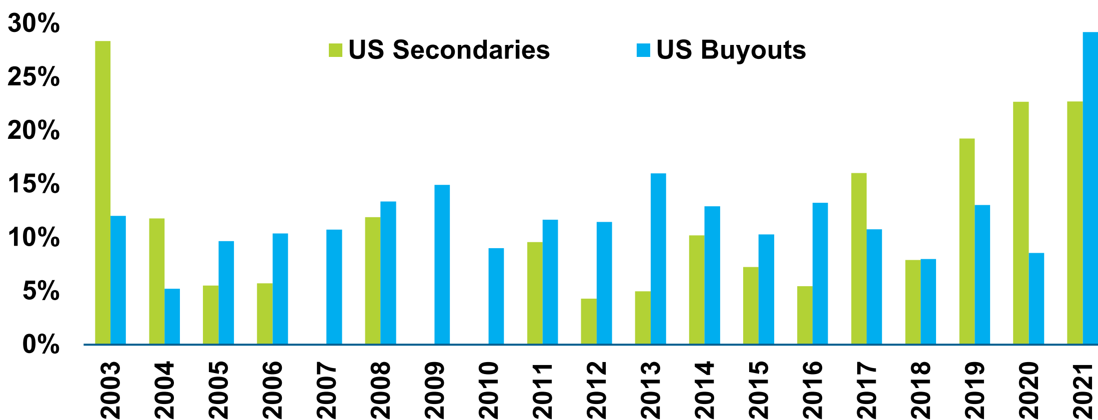

FIGURE 13
Interquartile Spread by Vintage Year

Source: Cambridge Associates via IHS Markit, annual Pooled IRR quartiles by vintage year as of December 31, 2023 (pulled in June 2024). Indices: Cambridge US Buyouts and Cambridge US Secondaries. Vintage years 2022 and 2023 are excluded as they are too recent to be meaningful in this analysis. Returns are net of fees. Vintage years 2007, 2009, and 2010 do not have data provided for US Secondaries.

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What are the benefits and drawbacks?

The secondaries market may provide numerous potential benefits to both buyers and sellers. These may come with drawbacks, though these can often be at least partially mitigated.

Benefits for buyers

Investing in secondaries can provide immediate exposure to private markets and can help mitigate the j-curve.[14] This is particularly attractive for investors who are in the early stages of building a private market portfolio or who are increasing their target allocation. Secondaries can also offer diversification, particularly to less mature programs, by providing exposure to new/different strategies, as well as older vintages, than what the investor is already exposed to. Because secondaries often transact at a discount to NAV, there is a built-in value tailwind for buyers. Since secondary transactions typically involve more mature funds (i.e., they are not "blind pools"), there is more visibility about the underlying investments and a better opportunity to model potential underlying investment outcomes. Likewise, because these funds are further along in their life, there will be a shorter period during which invested capital is locked in and management fees are paid.

Benefits for sellers

Secondary sales provide owners of private market funds greater flexibility to make changes to their portfolio. For example, secondary sales allow an investor to restructure their portfolio to meet strategic needs, such as a change in target allocations. Secondaries allow an investor who is over their target allocation to trim back toward their policy range instead of having to change another portion of their asset allocation (e.g., reducing public equities). Secondary sales can also be used to reduce exposure in areas the investor no longer finds compelling, and if they believe there are better opportunities available or coming to market, it will allow them to redeploy their capital in those opportunities.

Secondary sales serve as a means for consolidating the number of GPs an investor has to monitor. Finally, secondaries can provide "early" liquidity to investors who want or need it.

Drawbacks

There are some potential downsides for secondary market investors to consider. First among these is information disadvantages. The buyer in a secondary transaction generally has less information about the assets than the seller. As a result, there may be adverse selection in the potential deals available to secondary buyers. Sellers are likely to offer the largest discounts on assets that have been impaired since the most recent valuation date or that they believe offer the least upside potential.

Secondaries also generally provide relatively low TVPI compared to traditional private market funds. Per dollar paid-in, a direct fund is expected to generate more in gains over its full life than is a typical secondary fund/investment. This is because there is

[14] The J-curve effect is a common performance pattern in private market investments where returns are low or negative in the investment's early stages but increase as the investment matures. It may occur because while fees are being paid early in the life of a fund (or program), there are few investments made and even fewer assets being marked up in value.

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greater perceived upside in a new investment than in one that has already been owned and potentially enhanced by the GP. This expectation has generally been borne out in the long-term returns experienced by secondaries versus primary investments.

Finally, the secondary market is facing the double-edged sword of becoming more efficient. The secondary private equity market has become more institutional and seen a large influx of dedicated funds and capital committed to the space. The increase in competition may lead to a reduction in expected returns from secondary investments. This is partly mitigated by the significant growth in the available supply of secondary deals.

Conclusion

LP secondaries refer to when an LP sells their interest in a private market fund to a buyer, often at a discount to NAV. As part of the transaction, the buyer takes the seller's place (and corresponding unfunded liability) as an LP in the (unchanged) fund. The secondary market has evolved from its early days when a negative stigma was associated with it, into a more positively viewed market that allows investors a greater degree of flexibility in otherwise illiquid asset classes.

Private equity, and particularly the buyouts strategy, has dominated secondary market transaction volume. However, some secondary buyers focus on specific asset classes or sectors, which may allow for more effective underwriting.

As the secondary market has matured, it has grown more efficient. Secondaries' historical returns have remained relatively attractive and are slightly lower (particularly on TVPI) than buyouts' historical returns. The best returns for secondary markets appear to have been associated with periods of market distress when buyers were able to acquire secondary interests at steeper-than-normal discounts.

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