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Strategist views
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Alternative Allocations

Private equity: Secondaries anyone?

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During the recent environment of easy money and growing demand, private equity (PE) fundraising grew rapidly over the last two decades.

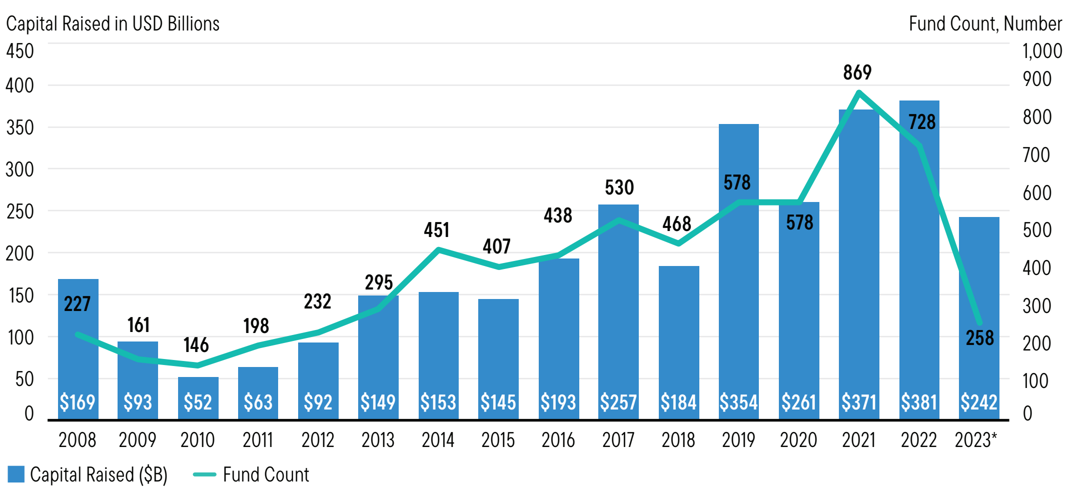
From 2011–2021, private equity generated 11 consecutive years of net distributions to limited partners (LP), meaning institutions could typically count on distributions offsetting commitments. However, as noted in our "2023 Private Market Outlook," private equity exits slowed dramatically in 2022, and continue to be stalled as of the writing of this report.

Private equity valuations reset from their lofty 2021 valuations. Higher interest rates and tighter credit conditions should put pressure on PE valuations, and investors may need to brace for a down round. Private equity fundraising is down substantially from its 2021 peak.

According to PitchBook,[1] "Exit value hit an air pocket in Q3, falling 40.7% from the prior quarter to its lowest quarterly level since the global financial crisis—and is now down 83.7% from the Q2 2021 peak." Exit activity is arguably the most important link in the PE chain of capital formation and an indicator of the health of the overall PE market. Exits fuel fundraising which leads to increased dry powder and the investment of capital. Exits also impact the allocation/reallocation of capital across institutions.

Exhibit 1: US Private Equity Fundraising Activity

*As of September 30, 2023



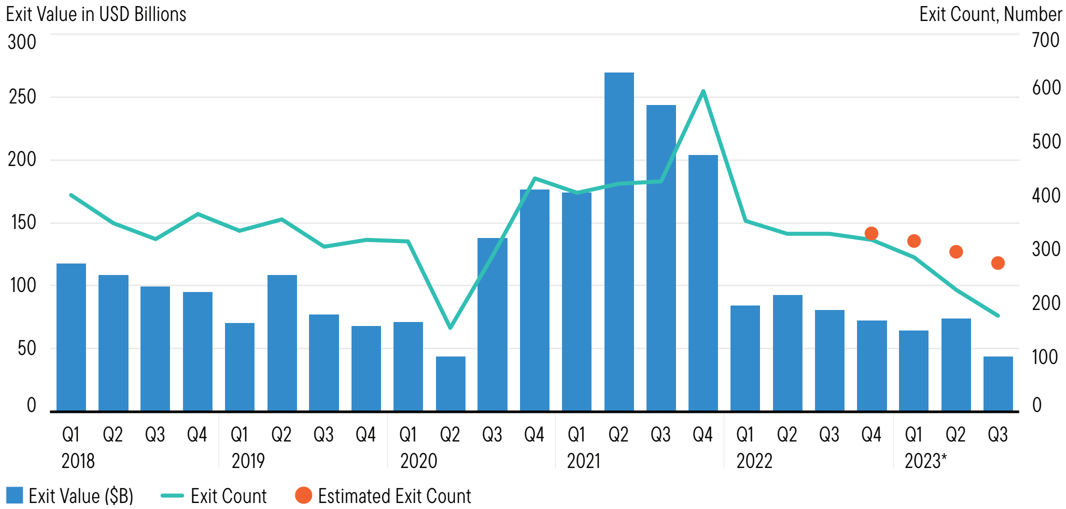
Source: PitchBook's US Private Equity Breakdown Report, Q3 2023.

Secondaries

While PE deals and exits have slowed, secondaries activity has picked up precipitously as institutional investors seek to rebalance their portfolios. Many institutions committed significant capital to PE in the last decade due to the potential for oversized returns. The expectation was they would be rewarded in the form of an illiquidity premium—the excess return for giving PE managers ample time to unlock value—and they would begin to receive distributions as investments reached the harvest period.

Exhibit 2: US Private Equity Exit Activity

*As of September 30, 2023



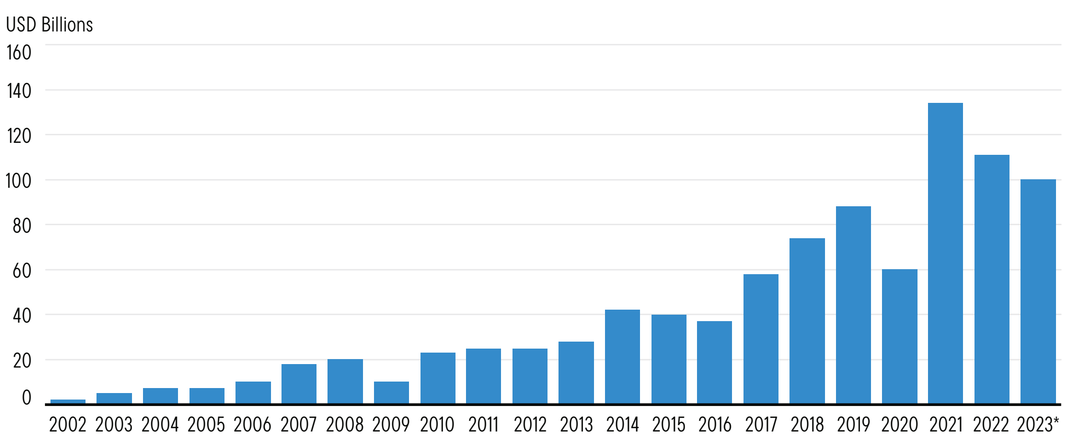
Source: PitchBook's US Private Equity Breakdown Report, Q3 2023.

As institutions found themselves overallocated to PE, they sought a means to diversify their holdings and still meet future commitments by accessing the secondary market. The secondary managers have been able to select from broad pools of assets to acquire attractive investment interests at favorable pricing. The managers benefitted from the significant inventory and the institutions' need for liquidity.

Secondaries managers can be selective in deploying capital, and can diversify across stages of development (venture capital, growth equity, and buyout), geography, industry, and vintage. By purchasing assets closer to their harvest stage, secondaries managers can mitigate the effects of the J-Curve, and investors may receive distributions sooner. Secondaries managers may also avoid troubled assets and select prized assets.

Exhibit 3: Secondary Market Transaction Volume (in US$ Billions)

*As of June 30, 2023



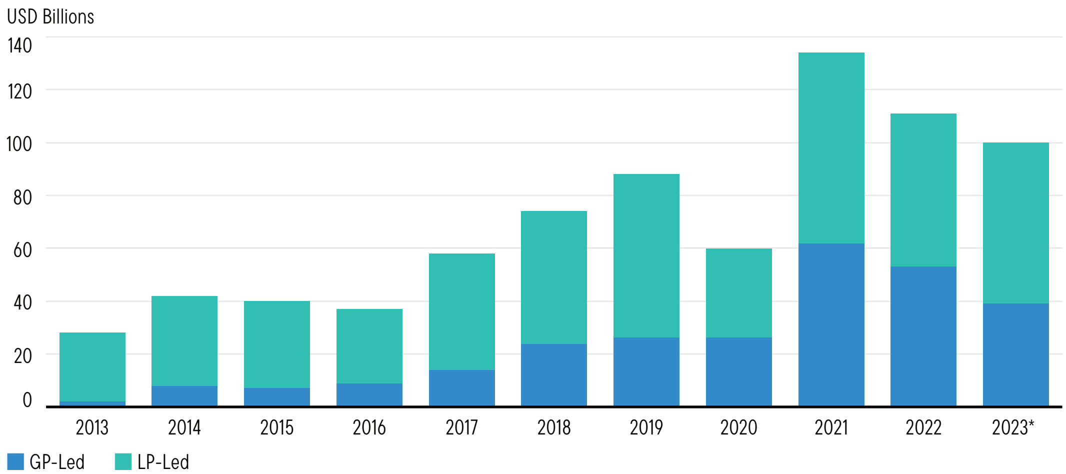
Source: Greenhill Global Secondary Market Review Data. *Greenhill's estimates for 2023 as provided in its Greenhill's Global Secondary Market Review, 1H 2023. Of the $100 Billion, the transaction volume for the first half of calendar year 2023 was $44 Billion.

There are two types of secondaries: "LP-Led" and "general partner (GP)-Led." In an LP-led transaction, a limited partner sells its commitment in a fund to a secondary buyer, who then takes on the rights and obligations of that LP in the existing fund. In a GP-led transaction, a GP-led single-asset continuation transaction, an asset or portfolio company is transferred from one vehicle to another vehicle, which can offer access to both additional capital and additional time to execute a value-creation plan.

Within GP-led secondaries, the single-asset model now stands as a functionally distinct segment, and single-asset transactions are the fastest-growing area within secondaries. GP-led single-asset secondaries can offer attractive benefits in all market conditions because of the flexibility for GPs to hold their most promising assets longer, and the possibility of added exit options.

Exhibit 4: Secondary Market Transaction Volume (in US$ Billions): GP-Led vs LP-Led

*As of June 30, 2023



Source: Greenhill Global Secondary Market Review Data. *Greenhill's estimates for 2023 as provided in its Greenhill's Global Secondary Market Review, 1H 2023. Of the $100 Billion, the transaction volume for the first half of calendar year 2023 was $44 Billion.

Secondaries valuations

The secondaries market has grown substantially over the last decade, from US$20 billion in 2006, to US$134 billion in 2021.[2] As the market has matured, more sellers access the market which has led to increased deal flow and LP portfolios are generally available at a discount to the underlying valuation.

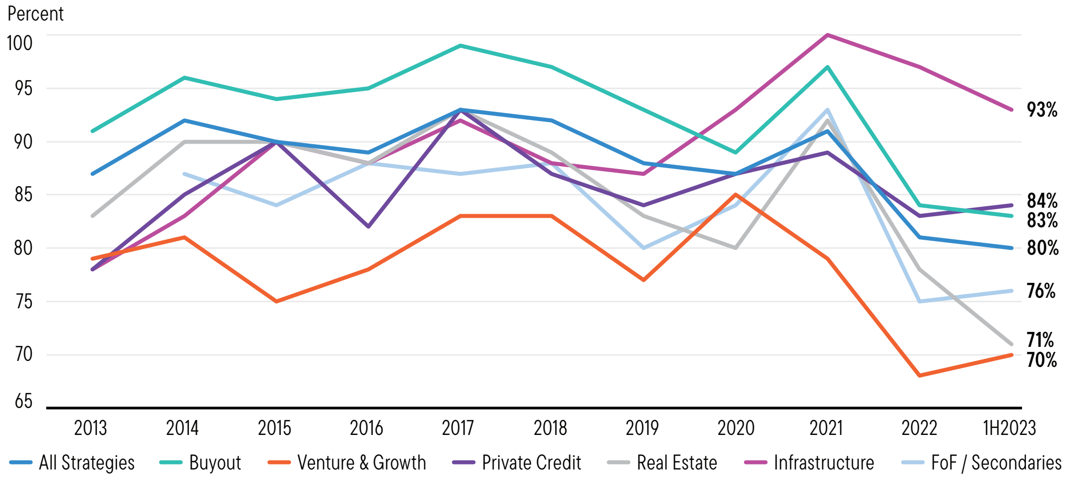
It is important to note that pricing varies across the private markets, with significant differences between venture and buyout valuations. According to Greenhill,[3] the average pricing for LP transactions rebounded to 80% of net asset value (NAV), with venture pricing at 70% and buyouts 83%, reflecting the divergence across the private-market ecosystem.

During 2022 and 2023, we saw increasing discounts as compared to the stable price environment of prior years, driven by the recent market volatility and an expectation for declining NAVs, which have resulted in more conservative underwriting by secondary buyers, which typically drives discounts wider. Investors are increasingly seeking liquidity as portfolio distributions decline, which drives increased volume. The elevated volume of portfolio sales comes as secondary industry dry powder dries up. We anticipate a period of higher average discounts will continue until NAVs stabilize for multiple successive quarters.

Secondaries have become a vital cog in the growing private equity ecosystem, providing investors with access to liquidity. Secondaries provide diversification and provide the broader ecosystem with additional scale and liquidity during periods of stalled exits.

Exhibit 5: Global Secondary Discounts

*As of June 30, 2023



Source: Greenhill Global Secondary Market Review Data.

Venture capital

According to Pitchbook,[4] "Venture-growth-stage startups face the harsh reality that median deal metrics have fallen more than 60% from record highs in recent years. The prolonged lack of liquidity and pullback of nontraditional investors have provided active investors ample leverage to demand higher equity stakes, with the 2023 YTD median notching a decade high of 14.9%." There has been a significant change in the market environment over the past 12 months, which has impacted valuations and capital formation within these innovative areas.

With respect to venture capital, we see a big difference between committed capital and new capital. Committed capital is dependent on when capital was committed, and at what valuation. Unfortunately, capital committed over the last couple of years is likely held at lofty valuations and may be dramatically different than the current valuation.

Conversely, managers putting capital to work today can be more selective in the investments they make, and the valuation of those investments. This could represent an attractive entry point for new VC capital.

Takeaways

Private equity valuations are being reset from their 2021 levels and exits have slowed to a crawl. Coming out of 2022, many institutions found themselves overallocated to PE, and/or unable to meet future commitments. Many sought to meet their allocation and liquidity needs by selling to secondary managers.

The private equity ecosystem represents a diverse set of opportunities from venture to growth to buyout, and provides diversified exposure across industry, across geography, and vintage year. Secondaries represent an attractive and growing opportunity to access this ecosystem.

To learn more please visit AltsbyFT Knowledge Hub. Knowledge Hub | Alternatives by FT.

Endnotes

1. Source: PitchBook. "PE Breakdown." October 2023.
2. Source: Collum, Chase. "Six key trends shaping the secondaries market." Buyouts Insider web site. June 1, 2022.
3. Source: Pitchbook. "US VC Valuations Report." November 8, 2023.
4. Ibid.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets**. Investments in companies in a specific country or region may experience greater volatility than those that are more broadly diversified geographically.

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