

SEVEN THINGS INVESTORS SHOULD KNOW ABOUT THE PRIVATE EQUITY SECONDARY MARKET



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Private equity (PE) secondary funds can provide several benefits to investors, including an accelerated pace of distributions relative to traditional primary PE fund investments. In addition, they can help investors enter new strategies, access top managers, and reduce blind pool risk. In this piece, we review secondary funds and their benefits by answering seven key questions.

1 | How Do Secondary Transactions Work?

A PE secondary transaction involves the purchase and sale of an investor's existing commitment to a PE fund—a pooled investment vehicle wherein capital aggregated by a group of investors, or limited partners (LPs), is allocated to a fund operated by an investment manager pursuing a growth equity or buyout strategy. When an original LP in a fund sells its position into the secondary market, it is selling both its current investment in the PE fund as well as any unfunded future commitments to the fund.

LPs are contractually bound to the fund partnership, usually for at least ten years. As general partners (GPs) identify companies to invest in, they call capital from the LPs over a defined investment period, typically four or five years. PE funds are privately held vehicles with legal restrictions and obligations. While GPs require a consistent source of committed capital to execute on their investment strategy, there are several reasons why an LP may seek to withdraw from its obligation to a fund before the fund's term has ended.

The acquisition of an existing LP commitment—including fair compensation for the value of the investments already made—marks the beginning of a traditional secondary transaction. In its simplest form, this is called an LP interest secondary, which was one of the first types of secondary transactions dating back to the late 1980s. The market has since evolved to include other types of secondaries ranging in complexity, size, and level of financial engineering.

Complexities aside, secondaries remain a way for current LPs to liquidate their interests while providing the GP with continued access to the originally committed capital. Given the nature of the contractual commitment, a secondary transaction is effectively an LP's only option to withdraw from their obligation and obtain liquidity. To make

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things even more complicated, the GP has the ultimate say in which buyer replaces the original LP and can restrict certain buyers from acquiring its funds.

2 | How Are Secondaries Traded?

Secondary transactions effectively work as an exchange. This is an important difference between a primary LP commitment and a secondary investment. On a primary basis, an LP is committing capital into a blind pool of future investments—they are trusting a GP to make future investments on their behalf. By contrast, a secondary buyer is acquiring another LP's access to the fund, including its exposure to the existing portfolio and commitment to paying off any remaining capital to the GP. In this way, blind pool risk is reduced in secondaries transactions because buyers are purchasing existing assets and portfolios.

3 | What Does the Secondary Marketplace Look Like?

The secondary market is made up of private vehicles and private transactions. While the underlying portfolio companies may be similar to a publicly traded security, they cannot be bought and sold on a stock exchange. As a result, these types of investments can be inefficiently priced. For a secondary seller and buyer, there is typically an intermediary involved to help parties come to an agreement. Intermediaries can add value by understanding in advance the GP's willingness to let a transaction go through and can also help gather and analyze comparable data to help LPs maximize price. However, in some cases, a seller who is under stress just wants to sell and may do so without sensitivity to price. These moments can become good opportunities for secondary buyers who understand what they are buying. Informed buyers often know the GP's track record, existing portfolio value, and expected cash flows quite well. Taking advantage of secondary opportunities requires significant due diligence on the buyer's part and we believe having an existing relationship with and an understanding of a GP can be a critical advantage.

4 | Why Does Either Party Want a Secondary Transaction to Happen?

When an LP interest is made available, the “seller” of that interest accomplishes several objectives via a secondary transaction. The LP is released from any remaining commitment—freeing up capital to rebalance its portfolio or invest in new funds while selling assets it had previously invested in. Secondary sales are an increasingly used tool in portfolio management by investors of all types and sizes.

Buyers may also gain in the exchange. They are able to obtain access to seasoned assets and may be able to generate compelling risk-adjusted returns. Arriving “fashionably late” can allow the buyer to assess a portfolio of companies as compared to the typical “blind pool” primary fund. Further, because sellers can be motivated to pursue a sale,

they may be willing to sell their interest in a fund at a discount to the current value—effectively re-pricing the return stream for the new buyer. We believe this discount can benefit the new LP or secondary buyer, even in instances when funds have not performed well for the original investors.

5 | How Can Investors Access Secondaries Transactions?

A secondary is a transaction with a legally binding contract involving a fair amount of negotiation. There are large and sophisticated institutional asset owners with the staff, resources, and understanding to execute on these transactions. However, to identify the right deal at the right time, most investors need a staff dedicated to secondaries that understands and/or has access to the underlying GP in the transaction.

6 | How Does Cambridge Associates Access Secondaries for Clients?

Cambridge Associates (CA) has a team of investment professionals with secondaries transaction experience that leverages a primary private investment platform of thousands of GP relationships. Historically, our secondaries team worked to identify specific transactions and offer them to investors on a deal-by-deal basis, which was akin to trying to buy a house with 30 partners in 30 days—highly complex and very labor intensive. Individual investors need to vet the deal with legal counsel or have an investment committee review—and there isn't enough time to act. This can lead to missed opportunities.

For a variety of reasons, we believe a commingled secondary vehicle makes sense for most investors. By investing in secondaries via an aggregation vehicle, we believe the CA Secondaries Team will continue to identify and selectively invest in attractive transactions and leverage the CA platform. Most importantly, the team will be able to act quickly to execute on deals they believe will generate compelling risk-adjusted returns.

There are many strong secondary buyers that we continue to recommend to our clients. Investors seeking to leverage CA's platform to access secondary opportunities should execute via the CA aggregation vehicle. Large investors can consider using a single fund structure that invests alongside the aggregation vehicle.

7 | What Else Should Investors Know About Secondaries?

The beauty of the secondary market is that it is constantly evolving and growing—even in terms of the transaction types. As complex as the above examples are, there is an additional layer of more nuanced and complicated transaction types that investors can access. Synthetic secondaries, for example, are large, structured transactions that access portfolios of companies that may sit inside a company or bank. There are also tail-end portfolios, which can be deeply discounted but also difficult to understand. Sector- and industry-specific secondaries also exist, as do a growing set of GP-led

secondaries, where GPs decide to take the remaining positions in their portfolios that they believe would benefit from a longer maturity date. In this instance, a new fund is formed and existing LPs from the prior fund can roll into the new fund or sell to a new GP. These continuation vehicles are becoming a larger component of the secondary market, and there are more secondary funds being launched that are dedicated solely to GP-led deals.

Taking Advantage of Secondary Opportunities

We believe the PE secondary market can offer investors efficiency and access that is unavailable elsewhere in the private investment universe. That said, when considering new or additional allocations, investors should remain mindful of their risk tolerance and portfolio goals to stay aligned with their broader objectives. In a dynamic, evolving secondary market, we believe partnering with a knowledgeable and experienced investment team is an important part of finding success within this asset class. ■

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