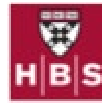

The Changing Secondary Market

A Webinar Sponsored by
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On December 16, 2021, a panel of academic researchers and practitioners met to discuss the nature of the secondary market for private equity and venture capital. This discussion explored the rapidly changing landscape of the secondary market from different perspectives, as well as the implications of these changes for asset owners. The panelists were **Paige Brotherton** (Coller Capital), **Sascha Gruber** (LGT Capital Partners), **Todd Miller** (Jefferies), and **Mike Weisbach** (Ohio State University). The discussion was moderated by **Josh Lerner** (Harvard Business School and Director of the PCRI).

The secondary market for private equity and venture capital investments rose from obscurity, with a mere $9 billion of transactions in 2009 to about $100 billion in 2021. In the early 2000s, the secondary market was primarily a tool for large limited partners ("LPs"), such as endowments, to obtain liquidity for their portfolios. Attitudes about the secondary market have shifted tremendously in the past decade. These markets were no longer viewed solely as vehicles for LPs to provide liquidity. Rather, they have evolved to enable complex general partner ("GP")-led restructurings of mature funds and an important part of the strategy for many private equity and venture capital funds. This creativity to address constituent needs has been a hallmark of the secondary industry.

The Evolution of the Secondaries Industry

Two notable waves drove the growth of the secondary markets. The first wave occurred after the bursting of the "dotcom bubble" in the early 2000s. During this time, many investors needed to get out of their illiquid investments. Many were overallocated into certain funds and were running out of capital.

The second big wave occurred during the Global Financial Crisis. Despite the fact that secondary transactions were being undertaken at a deep discount to net asset value ("NAV"), distressed LPs had substantial need for liquidity. The level of activity in the crisis years 2008-2010 was almost

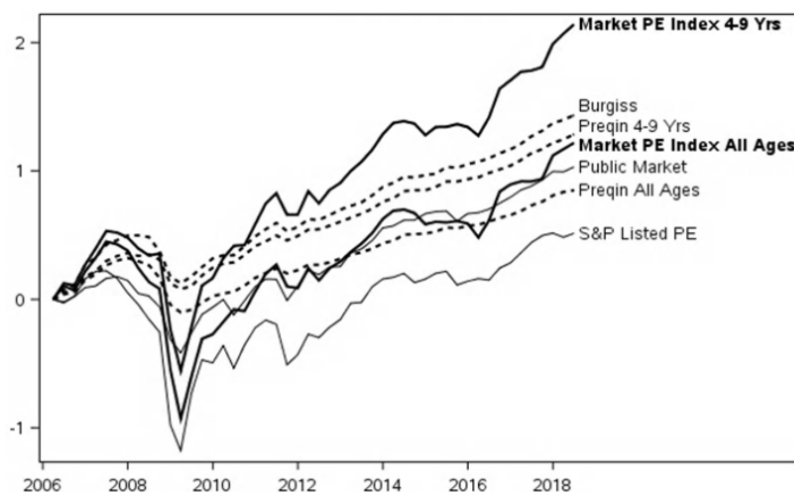
as large as the previous ten years combined.[1] Even though the window of opportunity was short, investors discovered that secondaries performed especially well. This increased awareness drew more funds to the market and led to a maturation of markets. In particular, while early funds had been generalists, this period saw the differentiation of strategies become more prevalent: e.g., funds specializing in particular asset classes (for instance, VC, credit, and infrastructure) and types of deals (e.g., GP-led transactions).

The Superior Performance of Secondaries

Research on the performance of secondary funds suggests that these investments do quite well, achieving an annualized internal rate of return of around 20% for the period from 2006 to 2017, largely driven by transactions in 4-9 year old funds.[2] Figure 1 compares the returns from investing in an index of secondary transactions involving buyout funds with the returns from a public market index and the indexes of (primary) buyout funds from Burgiss and Preqin.[3] The outperformance of the secondary transactions is evident.

Figure 1
Buyout Indices Over Time[3]

This figure illustrates the value of investing $1 in an index at the beginning of 2006 in each buyout index as labeled. “Market PE Index All Ages” and “Market PE index 4-9 Yrs” represent the indices we build based on PE secondary market transactions. The “Public Market” index represents the public market return as posted on Ken French’s website. “Preqin All Ages” and “Preqin 4-9 Yrs” represent the indices we build using NAVs as reported in Preqin for the exact same funds that are in our PE market-based indices. The Burgiss index is a NAV-based buyout index. The S&P Listed Private Equity Index is an index comprised of publicly-traded private equity funds. The chart uses a log scale for the vertical axis.



[1] Hege, Ulrich and Allessandro Nuti, The Private Equity Secondaries Market During the Financial Crisis and the “Valuation Gap”, *The Journal of Private Equity*, Summer 2011, Vol. 14, No. 3, Exhibit 1.

[2] Boyer, Brian H., Taylor Nadauld, Keith Vorkink, and Michael S. Weisbach, Private Equity Indices Based on Secondary Market Transactions (November 2018). Available at SSRN: https://ssrn.com/abstract=3278507.

[3] *Ibid.*, Figure 2.

One possible explanation for this strong performance is that the discount offered when the secondaries were purchased was much steeper than when sold. The average price discount over the full sample is 13.8% of NAV, though this discount varies with fund age and overall market conditions.[4] Since NAV is often already at a discount to an asset's underlying value, this implies an even greater discount. Furthermore, the risks involved are likely to be lower than traditional private equity and venture capital investments: the assets had a history and are typically more mature and already "locked in." Lastly, considering that the deal performance was measured as all-equity transactions, a levered secondary fund's performance could potentially be even more amplified.

Other panelists noted that the superior return of secondaries was often not due exclusively—or even primarily—to the initial purchase discount. They explained that the true discount or premium in a secondary transaction is difficult to assess, because it is based on NAVs. These values are updated infrequently. It was noted that an internal study by one firm found that there was no correlation between the stated discounts/premiums paid and the ultimate returns to their investments. Several panelists suggested that what is critical to performance is understanding the fundamental value of an asset, regardless of its stated NAV. They also noted that sellers often focus on aspects other than price alone. Some sellers may value the speed of a transaction or the ability to undertake a particularly large transaction over the highest price.

The Shift from LP to GP-Led Secondaries

As the longevity of private equity and venture capital funds increased over the years, with some funds not winding up until 15 or even 20 years pass, GPs have found that they had trillions of dollars locked up in funds. Along with increased volume of and narrowing spreads in secondary markets, longer holding periods have led to a huge growth in GP-led secondaries. These transactions now represent about 50% of the secondary market transactions.

The motivations for GP-led deals are different from traditional LP secondaries. Rather than focusing on liquidity (as characterizes LP-driven deals), GPs use secondaries as an avenue to preserve the assets they want to maintain while addressing the needs of their investors. Thus, when a GP has an asset that the fund partners want to keep owning, but are feeling pressure to return capital to their LPs, using a secondary with a continuation fund is an attractive option. The GP can keep the assets that they like and continue to create value in a new structure, essentially

[4] Taylor D. Nadauld, Berk A. Sensoy, Keith Vorkink, Michael S. Weisbach, The Liquidity Cost of Private Equity Investments: Evidence from Secondary Market Transactions, *Journal of Financial Economics*, Volume 132, Issue 3, 2019, Pages 158-181.

recapitalizing the deal while maintaining the current management and business plans. For an LP, there is an opportunity to cash out or stay in the asset.

GP-led deals are different in some respects from LP transactions. In GP-led deals, the discount offered may be relatively smaller than with an LP sale. This is in part due to the asymmetric information issues in GP-led deals. In GP-led deals, there is an inherent conflict: if the GPs price the transaction too cheaply or too steeply, they will have either unhappy current or former LPs. In addition, getting the pricing wrong could raise the attention of the SEC. Thus, GP-led secondaries tend to be priced closely to the underlying asset value. Given the information problems, there may also be more due diligence by the buyer than in a typical LP-driven process. Lastly, because GPs feel more passionate about their assets, they will likely spend more time on marketing.

There is some worry that the rise of GP-led deals is leading to the erosion of premiums earned in LP secondaries. Moreover, there is a danger that GPs could use secondaries as a means to charge more fees and generate higher carry. However, this is not necessarily a zero-sum game. What is most critical to LPs is understanding the motives of the GP for selling. There are many attractive deals, but LPs need to make sure there is an alignment of interest for the GPs.

The Future

With the secondary markets on track to reach around $100 billion in volume in 2021, it is unlikely the market will soon disappear. However, the extent of future growth will depend on several factors:

- One factor is the growth of assets under management in private capital more generally, which has experienced explosive growth over the last 15 years.
- Equally important is the rate at which these assets turnover. Currently, turnover is around 1% in each calendar year. The lengthening of expected fund life may increase this rate.
- Furthermore, the ability of secondary funds and investors to attract talent and capital will also be important in driving the growth of this sector. The good news is that secondaries are no longer an oddity in the market and recruiting talent into this sector has improved over time.
- Lastly, fintech could provide some solutions in this market by reducing transaction costs. Given the complex nature of many secondary deals and the extensive due diligence required for each transaction, the panelists felt that is unlikely that technology will soon play a huge role in driving this market.