Summit Strategies Group

Secondary Funds:

Is there still value to be captured?

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In 2015, the sentiment Summit heard from many institutional investors was a reluctance to commit to secondary funds given that pricing and dry powder for secondary investments were at historical highs. This paper addresses Summit's view on the current secondary climate and outlines the firm's approach to secondary allocations within client portfolios.

Evolution of the Private Equity Secondary Market

The secondary market for private equity has grown rapidly since 2001, with annual transaction volume increasing at a CAGR of 21%.[1] This growth has been driven primarily by LP-initiated transactions but GP-led deals are increasingly becoming a larger share of the market. As an example, GP restructurings, a relatively new type of secondary transaction, have increased significantly with some secondary experts predicting it will represent a quarter of transactions in 2016.[2] More complex transactions such as this are exploding in popularity and offer new opportunities for managers with specialized skill sets to address complicated situations with bespoke solutions.

Secondary Volume

Perhaps unsurprisingly, the amount of capital raised for secondary strategies has kept pace with the growth in the size of the market with over $19 billion raised for dedicated secondary funds in 2015 alone; a key driver of this is likely the tendency of successful secondary managers to raise larger and larger funds, with 2015 marking the first year a secondary fund raised more than $10 billion in commitments.[3] In addition, Summit has observed that virtually all diversified fund of funds managers have incorporated some element of secondary investments into their strategy; an estimated $17 billion was raised for fund of funds strategies in 2015, conservatively suggesting an additional $1-3 billion in capital dedicated to secondary transactions.[4] Some larger LPs are also beginning to build out direct secondary programs, adding even further to the capital chasing secondary deals.

What does this mean for participants in the secondary market?

The large amount of capital raised for secondary transactions combined with robust pricing in 2015 has led many LPs to question whether now is the time for further investment in secondary funds. However, Summit's research indicates there are still inefficient pockets of the broader secondary market where there is further value to be captured with the right managers.

[1] Neuberger Berman, *Secondary Private Equity Market (White Paper) Summer 2012* and Greenhill Cogent, *Secondary Market Trends and Outlook January 2016*
[2] Greenhill Cogent, *Secondary Market Trends and Outlook January 2016*
[3] Based on Summit proprietary data and Preqin; fund in question is Lexington Capital Partners VIII which raised $10.1 billion, more than $2 billion over its target.
[4] Preqin estimates total fund of funds capital raised in 2015 at $17.2 billion. Summit's research suggests most fund of funds have an allocation of 0-40% for secondary transactions.

What gives certain secondary managers an edge over the broader market?

Although LPs tend to lump all secondary managers together, a more granular approach suggests that there are still attractive, relatively less competitive areas where secondary managers can add value and provide strong risk-adjusted returns. A few of these are:

1) ***Managers that focus on smaller transactions:*** Although secondary volume in general has increased dramatically over the last 15 years, the growth in fundraising has been largely concentrated on funds that are greater than $500 million in size[5], suggesting that the neglected, smaller end of the market is less competitive as many players raise substantially larger funds and are forced to move into larger transactions. In addition, Summit has found most managers that focus on these smaller deals tend to use less leverage than their larger counterparts. This provides managers focused on the smaller end of the market with not only less competitive pricing situations, but more attractive risk-adjusted returns.

2) ***GPs with structural advantages:*** Summit has long believed that secondary managers who have an affiliated primary product have a competitive advantage over secondary managers operating on a stand-alone basis. As a primary investor, managers have more historical context and performance data on a fund's portfolio, providing them with an information advantage relative to stand-alone secondary managers. In addition, GPs often prefer to sell secondary interests to existing investors before bringing in a new party in the middle of a fund's term, making secondary managers with primary products a preferred partner and a first call for the secondary sale of many fund interests.

3) ***Strategy specialization:*** Although the secondary market is often discussed in general terms, there are still strategy types that are significantly less efficient than the broader market as a whole. One example of this is venture secondary, where median pricing has consistently lagged that of other strategies, often trading at discounts 10-20% below buyout secondary transactions[6] – the likely reason is the inherent complexity in the valuation of these assets, leading only managers with specialized experience to be successful and discouraging generalist managers from these transactions. Another way in which Summit has observed secondary managers differentiate themselves is by maintaining a developed expertise in more structurally complex transactions; GP-led liquidity solutions or restructurings are increasingly becoming a larger part of the secondary market but require a specialized skill set, and not all secondary managers are equipped to execute on them.

Conclusion

Summit's recommendation for the secondary space has always been to partner with managers that pursue off-the-run secondary transactions and that have some sort of an edge over competitors. From Summit's perspective, there are many differentiating factors that are likely to provide a more attractive risk-adjusted return. Summit believes that specialization in less popular strategies or leveraging a primary platform are likely to make secondary managers with these attributes a preferred partner for GPs, leading to better dealflow. Expertise in more complicated transactions or a focus on the smaller end of the market is also likely to help managers achieve strong returns due to less competition.

Secondary strategies tend to be cyclical and timing the market can be difficult. The investment climate can shift quickly over the commitment period of a fund and Summit believes the best approach to invest in secondaries is to commit to managers that have demonstrated an ability to consistently earn strong risk-adjusted returns despite broader market pricing, but still take advantage of more favorable valuations when there are periods of volatility and dislocation.

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[5] Preqin and Summit proprietary data. Note that funds with less than $50 million in commitments were excluded from this analysis.

[6] Greenhill Cogent, *Secondary Market Trends and Outlook January 2016*

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