An evolution in the world of private equity

The rapid growth of a secondary market in private equity has created new opportunities. It is not without its risks, however. By DWS Private Equity Solutions and DWS Insurance Coverage-Americas.

Over the past 20 years, private equity (PE) has grown to about $3 trillion under management globally through the middle of 2019, based on market data sources. Traditionally, investors – called limited partners (LPs) – have mostly gained exposure to underlying companies either via funds, which own companies directly, or funds of funds (which aggregate many PE-fund investments into a single product). Collectively, investment into a PE fund from "day one" is known as the "primary" market. Over the past decade, however, we have also seen growth of the PE "secondary" market – which specialises in buying funds and portfolio stakes second-hand from investors desiring early liquidity in these funds.

The private-equity market continues to be an inherently long-term, illiquid asset class, as evidenced by an average fund life of 15 years. With the increasing prevalence of secondaries capital in the market, LPs have been able to sell their stakes in private-equity funds prior to the end of the fund life. The most common type of secondary deal is known as a limited-partner transaction. A fund investor sells an interest, or a portfolio of interests, to another investor (a purchasing investor) based on a negotiated price, usually as a percentage of net asset value (NAV). The purchasing investor assumes the legal and financial obligations to the underlying fund(s).

Sellers are usually motivated to undertake these transactions for the following three reasons: active portfolio management, strategic and regulatory drivers or liquidity-driven situations. Over the past several years, for example, institutional investors ranging from large pension and sovereign-wealth funds to insurance companies, have begun to use a more liquid secondary market in order to re-balance exposures and reduce the number of private-equity relationships – effectively adopting traditional-asset-management techniques to managing their illiquid PE portfolios. Using the secondaries market has also become more economically attractive to sellers as the discount to NAV has narrowed in recent years and prices paid (on average) have increased.

Limited-partnership sales accounted for around three quarters of transaction volumes in 2017 (compare chart). The growth in secondaries really started during the global financial crisis ten years ago. Increased scrutiny and regulation of large financial institutions and banks led to strategic portfolio sales of illiquid and directly held private-equity assets and underlying private-equity-fund commitments. While this part of the market has historically generated attractive opportunities, its prevalence has waned in recent years as banks have reduced their balance sheets and exposure to private assets. Liquidity-driven or distressed situations can also still occur today, but have historically been less common.

Another, increasingly common type of secondaries are manager-led transactions. Managers – called general partners (GPs) – might seek liquidity options on behalf of investors for the remaining assets in a fund, while also potentially securing additional time (and sometimes capital) for a portfolio of legacy assets to mature and be primed for sale (usually called an "exit"). The structuring (or re-structuring) of these types of transactions can be complex and time consuming. Usually, it requires highly bespoke solutions around the composition of the underlying portfolio, the price to sellers, and the alignment between old and new investors, as well as the manager. GP-led deals and other non-traditional secondary transactions such as preferred-equity purchases, already account for between a quarter and a third of deal volume (compare chart) and we believe such deals may play an increasingly important role in the future.

Effectively, growth in the secondary market has contributed to somewhat greater liquidity in the PE asset class. The secondary market offers investors (in secondaries funds) instant access to a highly diversified private-equity portfolio; providing exposure across vintage years, sectors and geographies – while sellers benefit from an active buyer universe for their illiquid PE positions. However, the secondary market still remains much smaller than the primary market: less than 2% of private-equity assets are estimated to trade hands each year. Its rapid growth reflects structural changes in the market.

However, we believe there may be ways to get the best of both direct and secondary investing. By focusing on "stock-picking" later-stage investments within an existing PE-fund portfolio, new investors may be able to collaborate with a fund manager's

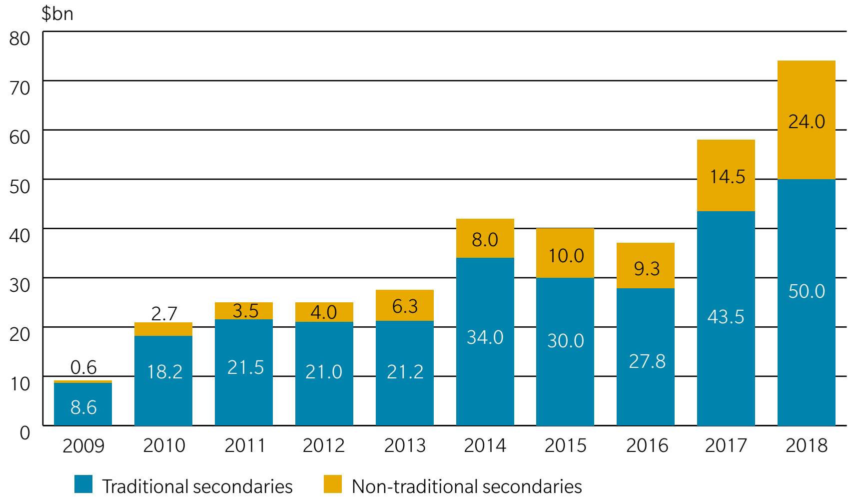
(GP's) best portfolio companies. Supporting these companies can ideally satisfy every stakeholder: new investor, incumbent investors, GPs, as well as the underlying portfolio companies. It may also result in higher returns relative to the market, not least by maintaining the key tenets of a secondary transaction (shorter duration, earlier distributions) while tactically identifying individual, attractive assets within an existing PE-fund portfolio. There are risks, however.

The market for secondaries has experienced record fundraising, with dry powder now at 2.6 times the supply of deal flow, more than double what it was six years ago (data from Greenhill, as of June 2019). As a result, the market has become far more competitive, making returns harder to generate, particularly for more "traditional" secondaries specialists.

In recent decades, the secondary market has grown rapidly, with volumes increasing from $9bn in 2009 to $74bn in 2018 (see Fig 1).

The continued evolution of the private equity market has led to the development of some different strategies that can offer investors differing opportunity sets than before, which can blend the characteristics of different fund types. For example, one approach can be a blend of direct buyout investing and traditional secondaries. These strategies, which focus on entering assets mid-hold can potentially deliver cash returns commensurate with traditional buyout funds but with a risk and liquidity profile associated with shorter duration secondary strategies. For insurance companies, particularly those with shorter liability durations like Property/Casualty and Re-insurers, such a strategy could provide access to cash flows sooner than a typical private equity fund. Strategies focused on entering assets mid-hold are generally expected to hold assets for 2-4 years, shorter than a traditional buyout fund's hold of 3-7 years, while still generating competitive net IRR returns (structured) (based on our analysis of data from public transactions through the first-quarter of 2019).

Fig 1: Secondary volumes at record levels



Sources: Greenhill & Co, Inc. as of 01/2017; Greenhill & Co, Inc. as of 01/2019; DWS Investment GmbH as of 6/13/19