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Excellence in Specialty Investments

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Private equity industry: secondary market on the upswing

Primary private equity fund investors are typically committed to an investment period of ten to twelve years. If liquidity demand or their portfolio strategy changes during this time span, they turn to the secondary private equity market. This leads to attractive opportunities for secondary buyers, especially if valuations in a primary investor's portfolio have fallen.

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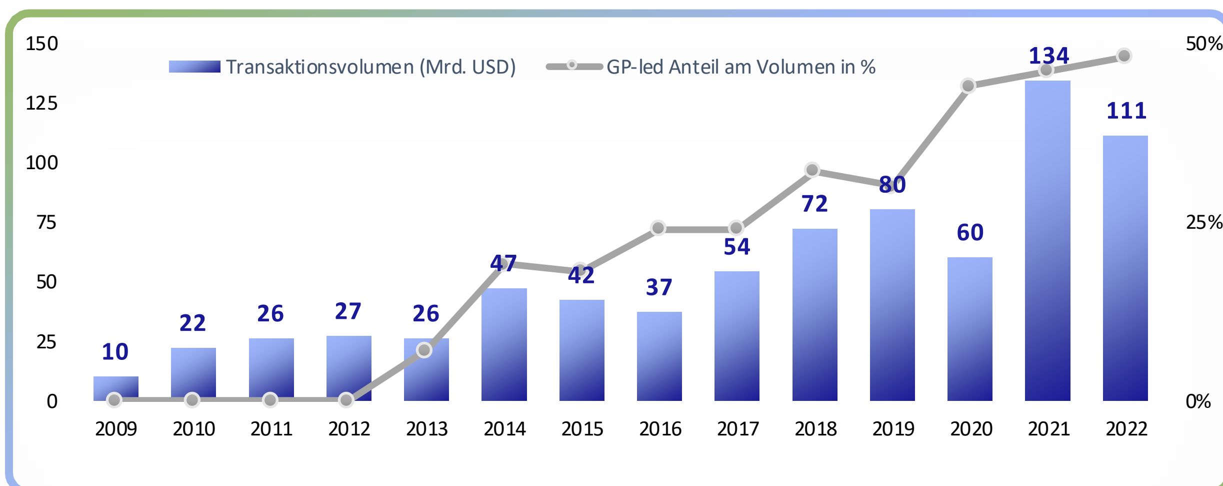
The secondary private equity market has evolved over the years, often in response to investors' shifting liquidity needs. In the early days, it was mostly investors in primary private equity market funds (so-called "limited partners" or "LPs" for short) seeking to liquidate some of their interests in the fund for whatever reason who turned to the secondary market, but the secondary market has also long been used in the meantime by the private equity fund managers themselves (the so-called "general partners" or "GPs") to generate liquidity for their investors.

The secondary market has grown steadily over the years. During the past ten years, its market volume has increased at annual pace of about 15-17%. Transaction volumes again exceeded the USD 100 bn mark in 2022 (estimates range from USD 103 bn to 111 bn), which makes 2022 the second most active year for secondaries after 2021 (> USD 130 bn).

Transaction activity is expected to remain high in 2023 with estimates ranging from USD 130 bn to 150 bn. Annual transaction volume is even expected to climb to USD 500 bn in the medium term. Annual secondary transaction volume still corresponds to less than 2% of all capital managed in private equity (in primary private equity funds), which amounts to approx. USD 8.7 trn according to the latest figures from data provider Preqin.

Transaction volume over time (USD bn):



Market participants in the secondary market have varying intentions, but they must always be seen in connection with developments in the primary market, the broader financial market and the general

economy. Last year, the basic motives of LPs who turned to the secondary market were the need to raise liquidity and the so-called "denominator effect":

LPs have sustained negative net cash flows from their investments in primary market funds for several years now: Capital calls by the GPs exceed the amount that is being returned to the LPs. Given today's environment, which is characterized by multiple contraction and therefore offers attractive investment opportunities for buyers but is not as favorable for sellers seeking to maximize the value of existing portfolio companies (exits), it is assumed that net cash flows will remain negative for some time to come. As a result, LPs are increasingly turning to the secondary market to raise liquidity from their private market investments.

Need for action among institutional investors

The denominator effect is particularly relevant for institutional investors as they must often adhere to strict rules regarding asset allocation. Due to the recent turmoil in financial markets and falling price trends for stocks and (as interest rates rise) bonds, the relative allocation to private equity has risen above the maximum portfolio weighting imposed on many institutional players, even if they have not actively allocated any additional capital to this asset class. In order to bring the portfolio weights back within the prescribed ranges, many institutionals sell some of their private equity investments in the secondary market.

LPs are also increasingly using the secondary market as a means of active portfolio management. This may be to sharpen the focus of their portfolios, to adjust the weightings of different strategies, or simply to prepare for the next round of fundraising by their preferred GPs.

GPs themselves have also discovered the secondary market in recent years. In 2013 GPs accounted for only 7% of the total secondary market volume, but, according to data from Greenhill, these so-called GP-led transactions accounted for a sizeable 48% of total transactions during the past year. There are two reasons for this:

Often GPs would rather not sell one or several of the companies in their portfolio just because a fund vehicle is nearing the end of its term (especially if the companies in question are expected to grow in value). Instead, these GPs will try to transfer these assets into so-called continuation vehicles so that they can continue to remain engaged in these companies. When arranging these transactions, existing LPs have the option of liquidating their investments. According to Greenhill, continuation vehicles accounted for no less than 84% of the GP-led volume in 2022.

Especially in times like today when the general environment does not favor going public and other exit options are somewhat limited, GPs can turn to the secondary market to raise cash for existing investors without necessarily relinquishing control over the assets in their portfolio by transferring high-potential companies to a continuation vehicle, where they can continue to provide funding with the help of new investors.

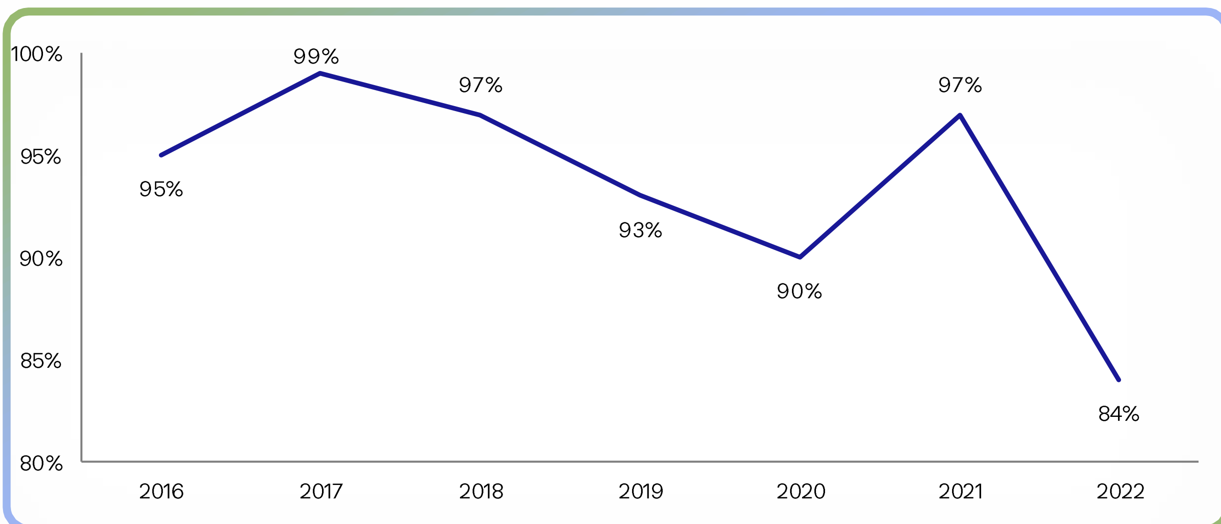
In contrast to a classic LP transaction, however, the GP-leds can entail some conflicts of interest and are much more narrow in scope (only one target company, or no more than a few, per transaction) than the fund interests an LP is seeking to sell in one or even several funds (so-called portfolio deals). Last but not least, a high degree of diversification and the associated reduction in risk are one of the most attractive attributes of a classic PE secondary strategy, as are early distributions and a less pronounced “J-curve effect” – or even the total absence thereof.

From a PE secondary fund perspective, the qualities described above are most likely to be achieved by giving LP stakes a high portfolio weighting.

A market commentary would not be complete, of course, without taking a look at recent market prices. The secondary market in 2022 was distinguished by occasionally significant discounts to Net Asset Value (NAV). In 2021, the average transaction price was still equivalent to 97% of NAV, whereas in 2022 that figure

was down to 84%. In the LP-led segment, the corresponding figure was an even lower 81%. Taking a closer look at the statistics, some of the GP-led deals closed at a premium of as much as 28% to NAV and 59% of all GP-leds were priced at 90-99% of NAV. Only 8% of all transactions involving LP stakes, however, were concluded at a premium to NAV; 49% were within a range of 80-89% of NAV and 24% were even priced at less than 80% of NAV. It also appears that this market segment – which still accounts for the lion's share of the secondary market in terms of the number of transactions – will continue to offer the most attractive conditions for buyers in the foreseeable future.

Price development for buyout secondaries (% of NAV):



Fund size becomes a problem

The smaller the transaction size, the more favorable the pricing for buyers was; an observation that we believe is mainly due to the fact that more and more dedicated secondary funds manage such large volumes that they can only place the capital they receive from investors in a timely manner by focusing on large transactions. As average fund volumes increase, the targeted returns have fallen, although there was a minor counter trend in 2022: 20% of the investors who bought individual LP stakes were only willing to do so if the projected minimum return exceeded 1.9x (gross money multiple). That is almost twice as high as in the previous year. However, a substantial 72% of buyers were satisfied with target returns of 1.5-1.9x, according to Evercore.

Bellevue is confident that a strategy that consistently focuses on smaller LP-led transactions ranging in size from USD 1 mn to 30 mn and on top-quartile small and mid cap buyout managers, building and managing a diversified portfolio that does not rely on leverage and that makes full use of the favorable secondary private equity market attributes, is well positioned to deliver gross returns of more than 2x.

Author: Benjamin Böhner joined Bellevue Asset Management in 2021 and is responsible for the business development of Bellevue Private Markets. Prior to that, he worked for Credit Suisse for more than 10 years in various management positions in investment advisory and product management, most recently as Head of Advisory Solutions. Böhner holds a Master's degree in Business Administration & Finance from the University of Hagen and is a CFA Charterholder.

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