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Barwon Private Capital Access Solutions

Investment *Whitepaper*

Exploring the Strategic Role of Private Equity Secondaries

Introduction

The last decade has witnessed a surge in private equity investment, transforming the financial landscape and fostering a new era of capital allocation. Investors have gravitated towards this asset class, drawn by the opportunity of substantial gains in an era of low interest rates. However, with the growing popularity of private equity investments, the need for increased liquidity along with the ability to rotate private equity investments has become more pronounced. This is where private equity secondaries step onto the stage, poised to play an increasingly pivotal role in addressing this liquidity and portfolio investment diversification requirement. As the private equity ecosystem expands and matures, secondaries will provide a solution by offering investors the means to exit or enter investments prior to their natural conclusion.

This investment paper will delve into the growth of private equity over the past decade, exploring the prominence of secondaries as a key investment instrument for enhancing liquidity, managing risk, the potential benefits for investors, and the role they can play in investor portfolios.

Private Equity (PE) investments have historically been a highly illiquid asset class, dominated by large institutional investors with substantial pools of capital, who were able to commit to long lock-up periods within closed-ended funds, and await a return of capital at a future date – often five to ten years from a fund's final close.

While PE has traditionally been focused on institutional investors, the landscape is evolving. Over the last 20 years, PE investing has established itself as a mainstream asset class, with a growing interest in making PE more accessible to a broader range of investors, including high-net-worth individuals and family offices. This is being done through vehicles like private equity funds of funds, feeder funds, and secondary market platforms.

The PE secondaries market has grown substantially as an asset class and comprises a variety of different styles of secondary investments. Secondaries can provide investors with significant benefits, including:

The potential to buy assets at a discount to net asset value ("NAV") or intrinsic value

Shorter duration than traditional primary funds

Reduced j-curve

Differentiated sources of alpha

Lower risk exposure to private equity assets

What are Private Equity Secondaries?

At their core, secondaries involve the buying and selling of pre-existing ownership stakes in private companies or funds, effectively allowing investors to enter or exit these positions without waiting for the natural lifecycle of the investments.

Secondaries tend to come in two main forms:

1. Limited partner led ("LP secondaries") and
2. General partner led ("GP secondaries").

LP Secondaries refers to the buying and selling of existing private equity (primary) funds and commitments, and is initiated by the LP (the fund investor), whilst the GP Secondary refers to the buying and selling of existing privately owned companies or portfolios, where the sale is initiated by the GP (or private equity sponsor). There is also a third type of secondary transaction, a more structured solution whereby capital is provided to a PE fund or continuation vehicle using net asset value (NAV) as collateral. This is like preferred equity and is another source of liquidity for LPs seeking an exit whilst while the GP retains control of the underlying fund / companies.

Secondaries involve the buying and selling of pre-existing ownership stakes in private companies or funds without waiting for the natural lifecycle of the investments.

Private Equity Secondaries – A Brief History

The first large wave of secondary PE activity began in the early 1990s following changes in bank and insurance regulations. This early phase of secondary activity was characterised by the sale of existing PE funds and commitments (LP secondaries) that were difficult to place with interested buyers, and by distressed sales with LPs needing to create liquidity or exit commitments. The asset class has now evolved into something more meaningful – offering genuine liquidity in an otherwise illiquid asset class and can provide other portfolio construction benefits. The number and scale of dedicated secondary investors has also grown with the market, highlighting the investment opportunity for investors in buying private equity exposure through the secondary market.

History tells us that during times of significant market dislocation, such as the recent period, some of the most attractive buying opportunities for secondaries tend to arise. The current rapid ascent of secondary transactions within the private equity landscape can be attributed to the heightened volatility witnessed in listed markets, a sluggish IPO market and a contraction of M&A activity, all prompting investors to explore alternative paths to unlock value and liquidity.

Against this backdrop, the rise of secondary transactions emerges as a strategic avenue for investors to access liquidity requirements and for secondary market investors to access the portfolios of leading GPs.

Source: Jefferies - Global Secondary Market Review, January 2023

Types of Private Equity Secondaries

Below is a summary table of the key types of secondaries in the market today. There are other types of investments/transactions which can be considered secondaries (such as GP stakes); however, this paper will focus on what we consider as core within the private equity secondaries market.

	LP Secondaries	GP-led Secondaries		Structured Secondaries
		Portfolio	Single Asset	
Asset Diversification	High	Medium	Low	High
Manager Diversification	High	Low	Low	Variable
Access to Leading GPs	Variable	High	High	Low
Duration	Generally short, but potential for long tail	Variable	Variable	Variable
Return Targets	High IRR, low MOIC	Private Equity-like	Private Equity-like	Structured Equity

GPs, are looking to secondary managers, and the growing array of GP-initiated secondary solutions on offer, as a means to provide liquidity to their LPs and to extend hold periods for their highest-quality assets.

LP Secondaries

LP secondaries, also known as "fund secondary transactions" or "traditional" secondaries, occur when LPs sell their interest in PE funds in a private transaction to a third party. Upon closure of an LP secondary transaction, the buyer will become entitled to receiving all distributions from the fund and will also be liable to paying all future capital calls made by the fund.

Advantages of LP secondaries for Buyers

Investing in LP secondaries offers prospective buyers with an immediate way of generating PE returns without being subject to some of the principal drawbacks associated with the asset class. Some key advantages of these fund secondary transactions for the buyer include the following:

Advantage	Comment
No Blind Pool Risk	Buyers of LP interests can assess the actual holdings of the fund, enabling them to make more informed decisions when buying / selling.
Flatter J Curve	More immediate capital deployment minimises J-curve risk associated with typical primary fund commitments. (See figure 1.0 and 1.1 in appendix)
Due Diligence	Ability to obtain fund level data to enable LPs to complete detailed due-diligence on underlying assets
Access to Managers	LP secondaries provide a way for investors to access high-quality GPs they may have perhaps otherwise struggled to get an allocation for.
Discounted Entry	Opportunity to access high-quality GPs at an entry price representing a discount to underlying NAV.

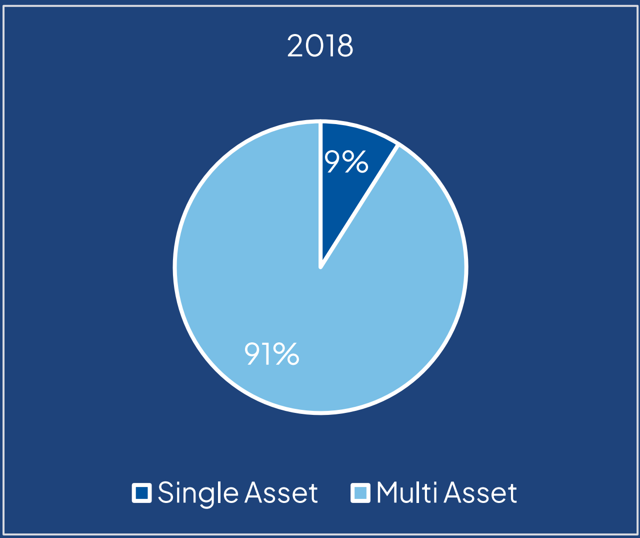
Advantages of LP secondaries for Sellers

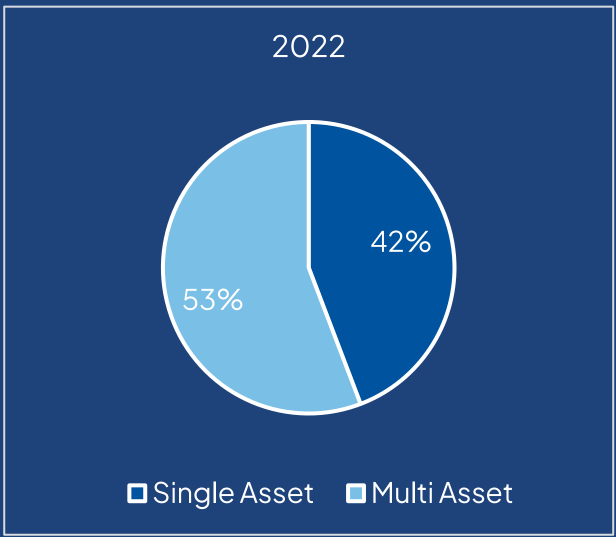
Analogous to the above advantages for buyers, fund secondary transactions offer some pertinent advantages for the sellers (LPs) including:

Advantage	Comment
Liquidity	LP secondaries provide a means to generate liquidity from an otherwise illiquid portfolio allocation
Rebalancing of portfolio	Particularly attractive for asset owners whose portfolios are out of balance due to the so-called denominator effect
Reduction of future capital commitments	Selling LP interests in secondary transactions relieves the existing LP from any remaining capital call commitments, this may free up capital for other investment opportunities

GP-led Secondaries

GP-led secondaries can be portfolio sales (typically of tail-end assets in a maturing fund), or single companies. In the case of portfolio sales, it is typical to sell a tail of assets in a fund which is approaching maturity and wind-up. However single company secondaries also include a more recent growth phenomenon of single asset continuation vehicles (SACVs).





Source: HarbourVest – GP-led Secondaries: A dynamic market with increasing liquidity benefits

SACVs provide a tailored solution, enabling investors to maintain direct ownership and engagement with promising assets, while simultaneously enabling sellers to access liquidity without compromising the potential upside. Unlike LP secondaries, which only benefit the LP and have no impact on the GP, single asset secondaries provide benefits to both partners in the fund. SACVs have been used to prolong ownership periods for assets the GP is not willing to surrender to other buyers. This allows the GPs to "run their winners" for a longer period, and continue the proven value-creation strategy, without being constrained by their need to distribute capital back to LPs within a constrained fund life.

The secondaries market has seen tremendous growth in recent years, with the GP-led market (and particularly single-asset continuation vehicles) being a big driver of that growth. This growth in single asset deals coincides with other trends observed in the PE market, most notably the structural shift to longer ownership periods of private companies.

Advantages of GP secondaries

GP-led secondaries offer a solution to the pressure faced by GPs to return capital to LPs towards the end of a 10-year fund's life. This liquidity pressure can lead GPs to sell successful companies to meet capital return demands from investors. However, through GP-led secondaries, GPs can maintain control of high-performing assets, execute their investment strategy, and satisfy LPs' distribution needs. This approach reduces the reliance on traditional exit methods such as sponsor-to-sponsor transactions or trade sales to provide liquidity to LPs. GP-led secondaries enable the manager to retain control of assets until they are prepared for a complete exit, without being beholden to LP distribution requirements.

For GP secondary investors, this strategy can provide some very compelling opportunities. SACVs can provide attractive private equity returns, but with the added benefit of being substantially de-risked (through both deleveraging and the GP having proven-out the initial investment thesis). Furthermore, SACV investments tend be shorter duration, with the GP's investment plan substantially underway before the investment is made. Finally, this structure allows those liquidity providers (the GP-led secondary investor) to be selective in choosing preferred deals with trusted GPs.

Returns for GP-led secondaries vs LP secondaries

GP-led secondaries and LP secondaries represent distinct approaches within the secondary market, each offering different potential returns and risk profiles. A key characteristic of LP secondaries is their often-immediate cash flow, resulting from the investment in mature portfolios. This often results in a very high internal rate of return (IRR) early in the life of the fund, albeit this typically moderates over the life of the fund. LP secondary fund performance tends to offer lower multiple on invested capital (MOIC) than primary funds and GP-led secondary funds, however typically with lower risk on account of lower variability between quartiles.

GP-led secondary fund performance tends to sit between that of traditional primary PE fund performance and LP secondary fund performance. GP-led secondaries are appealing irrespective of market conditions due to the structuring of these assets. They typically involve the prospect of a GP holding their best assets for longer and exiting at a higher valuation at a later date. Additionally, GP-led secondaries involve exposure to more concentrated portfolios as opposed to more diversified exposures in the case of LP-secondaries. As a result of this different structure, single asset secondaries tend to outperform their fund secondary counterparties with recent studies revealing c.62% of secondaries investors are targeting Net IRRs of 20% or more in single-asset secondaries compared to c.16% for LP-led secondaries.

Secondary Pricing

Pricing of PE secondary transactions is usually done with reference to the NAV of the fund / asset being sold. For a fund to be a sold at a discount to NAV suggests that the buyer does not ascribe the same value to the fund as its valuation suggests, inversely a fund sold at a premium to NAV implies that the buyer is optimistic about the prospects of the fund and is willing to pay more than its current valuation for the assets. Pricing for LP secondaries has been volatile and has fluctuated in response to macro factors, much in the same way listed assets are influenced by movements in key macro variables. LP secondaries currently trade at a c.13% discount to NAV (as at 31 December 2022) which is amongst the widest discount Barwon has seen across the sector over the last 15 years - (see figure 1.3 in appendix).

Pricing for GP secondaries, unlike their LP counterparties is more closely linked to the asset's carrying value than LP secondaries, given that the transaction will typically set the price/valuation as at the date the sale is agreed. Having said that, pricing of GP deals tends to be less contested as the GP and the secondary investor are typically well-aligned in their future interest in the asset.

Conclusion

In the ever-evolving landscape of private equity investing, secondaries have emerged as a transformative force, offering investors a versatile toolkit to navigate the complexities of the market. With the potential to reshape portfolios, enhance liquidity, and manage risk, private equity secondaries present a dynamic array of benefits that resonate across a spectrum of investor objectives.

For investors with an existing exposure to private equity, secondaries can be an attractive additional sleeve to that exposure, providing greater diversification and portfolio construction benefits.

However, the characteristics of shorter duration, and typically lower risk profile, make secondaries a natural first step into private equity for investors new to the asset class. As the secondary market continues to evolve, its role as a potent tool for unlocking value and managing private equity investments is set to solidify, contributing to a more resilient and adaptable investment ecosystem for both institutional and individual investors alike.

Appendix

Barwon's Involvement in Secondaries

Throughout Barwon's 16-year history, we have seen significant deal flow in PE secondaries through our relationships with both GPs and specialist secondary market brokers. Barwon's flagship Global Listed Private Equity strategy ("GLPE") invests in a portfolio of Listed Private Equity securities and in many regards can be seen as a portfolio of private equity secondaries, which happen to be traded on public exchanges.

We believe private equity secondaries are compelling investment strategies through-the-cycle. However, they are particularly compelling at this point in the cycle when account is taken of the discount they trade at relative to NAV, currently amongst the widest we have seen in our history of following the asset class.

History of Secondaries

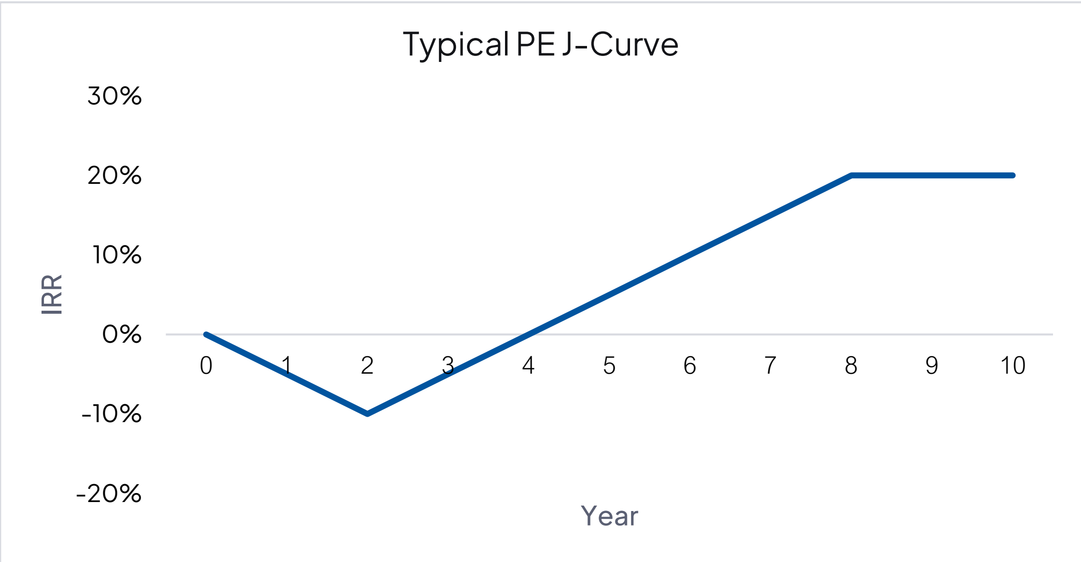
Date	Milestone
1946	American Research & Development Corporation (ARD) founded by George Doriot and JH Whitney – institutionalized PE funds begin.
1958	Investment Company Act of 1958 creates Small Business Investment Company (SBIC) program designed to provide funds for privately owned and operated VC investment firms.
1968	Bull market for IPOs: ARD takes Digital Equipment public generating IRR of 101%; raises profile of VC as alternative asset class.
1972	Kleiner Perkins raises $8.5m for its first VC fund.
1977	KKR executes 1st buyout transaction.
1978	Capital gains tax slashed from 49.5% to 28%: Labour Department clarifies that pension plans can invest in PE.
mid-80s	Private equity assets increased from $5 billion in 1980 to over $175 billion in 1995. Secondary deals occurred but at the rate of 1-2% of total assets and were one-off deals.
1984	First dedicated secondaries fund raised by VCFA ($6 million).
1988	A handful of secondaries funds exist. Jeremy Coller of secondary fund manager-fame, Coller Capital, completed the first secondaries transaction in Europe while working at the ICI pension fund. Nearly all deals involve the opportunistic acquisition of LP interests from a forced or distressed seller.
1990	Adams Street Partners raises the largest secondaries fund ($US 200 million).
1994	Secondaries remains a cottage industry. In the four years 1991 to 194 a total of $1.6 billion is raised.
1997	Secondaries market continues to grow but slowly and remains a localised phenomenon. Less than $3.6 billion is raised for specialist secondaries funds in the seven years 1991 to 1997.

1998	Coller International Partners II becomes the first global secondaries fund. Lexington Partners closes a $1.1 billion fund. Coller Capital's $265 million portfolio from Shell's US Pension Trust is the largest ever secondaries deal.
2000	Total secondaries funds raised 1991 to 2000 amount to $10.4 billion. First single transaction above $1 billion completed, the acquisition of NatWest's private equity portfolio following its takeover by Royal Bank of Scotland.
2001	Direct secondaries market begins to take off. Firms such as Industry Ventures, W Capital and Cipio are established as direct secondaries specialists.
2002	First $US 2 billion fund raised.
2003	Largest secondaries deal completed (€1.5 billion). A consortium of secondaries investors acquires a private equity portfolio from Deutsch Bank.
2004	Secondaries funds raised $US 11 billion in the two years to December 2004
2005	Annual volume of secondaries transactions exceeds $8 billion.
2006	Annual volume of secondaries transactions exceeds $10 billion. As the market deepens, specialist intermediary firms emerge such as: Cogent Partners (now Greenhill Cogent) (2000), Campbell Lutyens (1999), UBS (early 2000s), Setter Capital (2006) and Credit Suisse (early 2000s). These firms facilitate many transactions through deal sourcing and running bid processes.
2007	The early secondaries firms begin to scale. Coller V closes at $4.8 billion; Lexington $3.6 billion; Partners Group €1.5 billion; AXA (now Ardian) $2.9 billion.
2008	Global Financial Crisis impacts secondary market volumes which drop slightly from $16.1 billion in 2007 to $15 billion in 2008. The rapid fall in public equity market valuations is reflected in lower private equity NAVs with a lag. Investors wait for the valuations to settle. Structured liquidity solution providers such as 17 Capital emerge. Instead of buying secondary positions outright, structured solution providers provide debt or preferred equity secured against private equity assets.
2009	Market volatility in the wake of the Lehman Brothers crash leads to mismatched pricing expectations and low transaction volumes. In the second half of the year bid-ask spreads begin to converge and the market begins to stabilise.
2010	The volume of secondaries transactions exceeds $20 billion for the first time.
2011	The volume of secondaries transactions exceeds $24 billion. For the first time pension funds are taking advantage of the depth in the secondaries markets to tactically re-weight and re-shape their portfolios. And banks and insurance companies become strategic sellers to reduce their private equity exposures, mostly in response to new regulatory capital requirements.
2012	The volume of transactions exceeds $25 billion for the first time. The purchase of a $1.9 billion private equity portfolio from Lloyds Bank is the market's largest syndicated secondaries investment.
2013	A rapidly rising equity market slows re-balancing sales as the "denominator effect" results in private equity allocations falling as a percentage of total pension fund portfolios.
2014	Secondary market volumes leap to $40 billion as financial institutions seek to comply with the new regulatory capital requirements and investment limitations.
2015	GP-led liquidity solutions emerge as a significant part of the secondary market as investors and GP's look for solutions for tail fund assets and for investors with different liquidity requirements.

2016	The secondary market continues to evolve and diversify into new assets and areas. The market broadens out from private equity to encompass real estate, infrastructure and credit.
2017	$52 billion worth of secondary assets traded, a 40% rise over 2016.
2018	Another record year with $72 billion of secondary transactions. Coller Capital led the world's largest ever secondary transaction of its time with a liquidity offer for €2.2 billion to Nordic Capital investors.
2019	Transaction volumes reach $85 billion.
2020	Transaction volumes are impacted by Covid-19 but GP-led transactions stepped up to a new level.
2021	Goldman Sachs, Houlihan Lokey and Jeffries launch secondaries advisory practices, adding to the list of established advisory groups.
2022	The secondaries market continues to deepen and diversify beyond core private equity including agriculture, credit, real estate and infrastructure. Calpers is selling a $6 billion private equity portfolio. New York Teacher's Retirement Fund sold $2.6 billion.

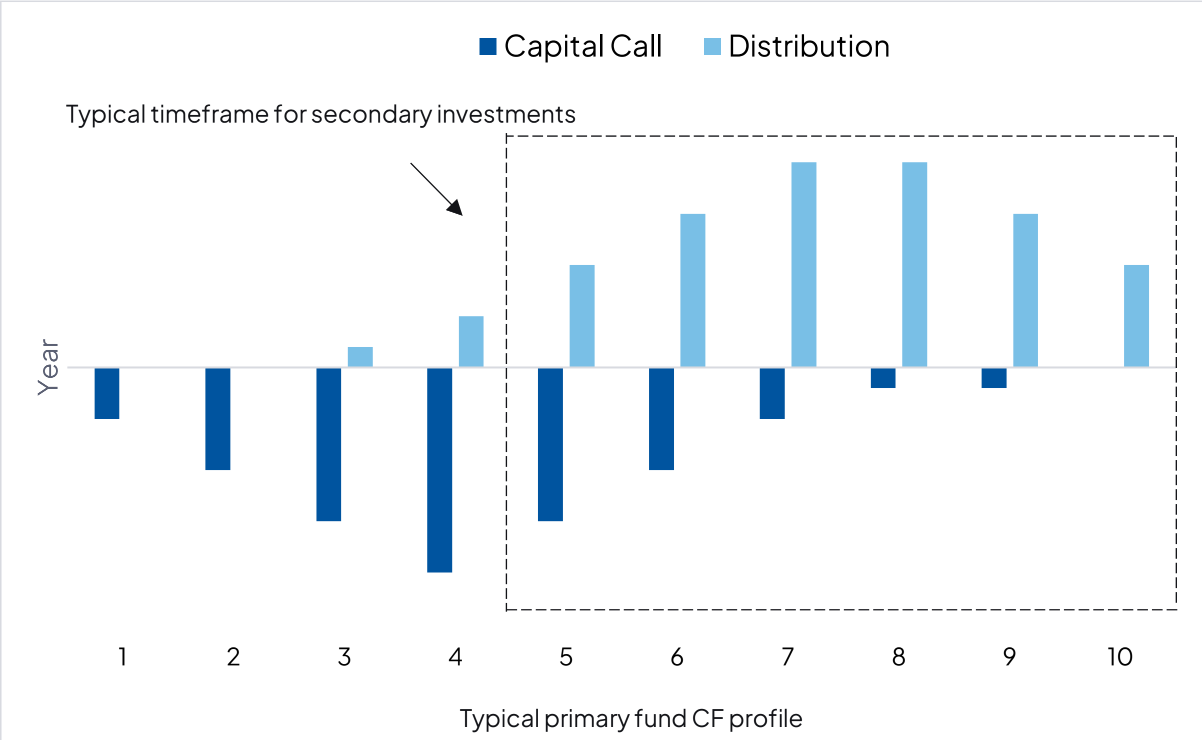
Source: Preqin; Coller Capital

Figure 1.0



Source: Barwon Investment Partners

Figure 1.1
Primary Fund Cash Flow profile

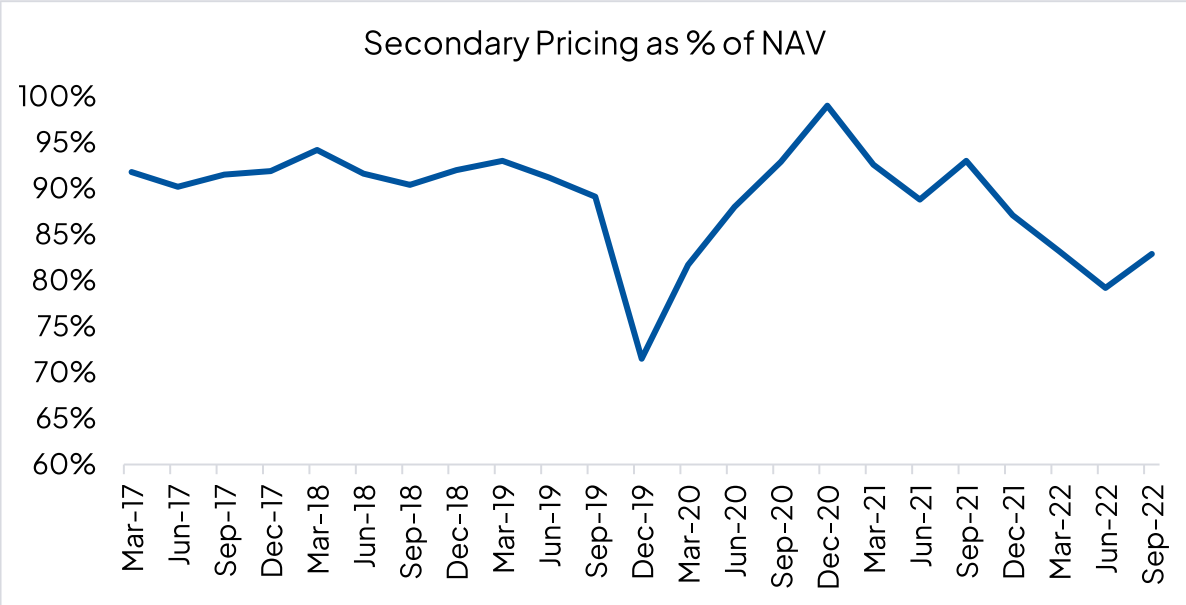


Source: Barwon Investment Partners

Figure 1.2
PE Secondary Market Stats
Annual transaction volume $US B

Source: Jefferies – Global Secondary Market Review

Figure 1.3
LP Secondary Pricing History



Source: Jefferies - Global Secondary Market Review, January 2023

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