“Undiscovered” Secondary Markets

The private equity secondary market is fairly well known, and one could argue it has become heavily trafficked in recent years. Other secondary markets—such as those for hedge funds and private credit—may be less familiar to investors. While these markets are smaller, transactions can offer compelling returns. With the majority of return coming from realization of discount to net asset value (NAV), these investments can offer important risk mitigation benefits as well. This may be of particular interest today, against a backdrop of lofty valuations for many asset classes.

Private equity fund investors seeking to sell interests on the secondary market have been met with robust demand. According to Preqin, the private equity secondary market has grown over five times in the last decade. Today, private equity secondary buyers collectively manage $280 billion with $125 billion of dry powder.1 (Display 1) This has resulted in high transaction volumes at limited discounts to net asset value for traditional private equity secondaries.

In contrast, alternative fund investors seeking to sell illiquid assets not comprised of private equity have not been met with this same level of demand. In fact, private equity secondaries comprised more than 90% of all alternative fund secondaries.

1 Preqin Secondary Market Update: H1 2020
in 2020, leaving less than 10% in hedge funds, infrastructure, real estate, real asset and private credit funds combined. (Display 2)

Whereas the private equity secondary market is characterized by large intermediaries, transparent processes, cooperative general partners, standardized settlement mechanics and many well-capitalized buyers, the opposite conditions exist for other types of alternative fund secondary markets. We believe this vastly different demand dynamic presents a rich opportunity set for buyers who are able to pursue “undiscovered” secondary markets. Buyers may benefit from less efficient pricing and higher discounts to NAV. Compared to private equity secondaries, these higher discounts provide greater downside protection and make the strategy less reliant on growth in asset values and leverage to achieve returns. Below we delve into reasons why the demand dynamic differs—why we think that will persist—and why the dry powder within the private equity secondary market has not reached other alternative asset categories, notably hedge funds and private credit.

**Transaction Size**

The average size of private equity secondary funds raised in 1H 2020 was $4 billion. To efficiently deploy that capital, focusing due diligence on material position sizes and avoiding excessive line items, these private equity buyers tend to target average transaction sizes greater than $100 million. While the total hedge fund market is $3.6 trillion, the majority of that capital is redeemable at NAV and unlikely to require a secondary sale. When secondary needs do arise in illiquid hedge funds, the transaction size infrequently exceeds $50 million. Similarly, while private credit assets under management have grown substantially over the last decade, at $800 billion the industry remains a fraction of the size of the $4 trillion private equity market. (Display 3) As is the case for hedge funds,
this leads to lower transaction volumes and smaller transaction sizes for private credit secondaries. Because of their need to traffic in fairly large size, private equity secondary players find themselves confined to the one market that can supply large transactions today, traditional private equity. And they continue to aim their dry powder accordingly.

**Asset Class**

By mandate and experience, private equity secondary players focus on funds that contain control private equity positions. Secondaries that arise in other types of alternative funds may include private equity, but typically span several asset classes including credit, litigation, real estate and real assets. Furthermore, the fund manager (or sponsor) may or may not have a control position. Private equity secondary buyers are not apt to traffic outside of their core asset class mandate, leaving these other alternative categories without a natural incumbent buyer.

**Structure**

Private equity fund structures are fairly homogeneous. They are generally closed-ended with an investment period, a harvest period and extension options; they usually charge a management fee and carried interest over a preferred return. Investors typically own a pro-rata portion of all investments in the fund. When secondary opportunities arise in hedge funds, the structures are quite disparate. For instance, illiquidity could be the result of an initial lock-up, a side pocket, a suspension in redemptions or myriad other reasons. Depending on the structure, hedge fund secondary investors could own a pro-rata portion of the fund or they could own underlying assets in differing portions. Fee structures are frequently modified and may differ between liquid and illiquid assets. These variables require nuanced due diligence, presenting a barrier to entry for potential buyers unaccustomed to such complexities.

**Relationships and Alignment of Interests**

While there are a small number of asset managers that span alternatives, for the most part the universes of private equity managers and hedge fund managers are distinct. Private equity secondary players tend to have relationships with private equity managers, but little familiarity with hedge fund managers. Hedge fund managers have no particular incentive to cultivate relationships with private equity secondary buyers. While private equity managers have the incentive to find buyers able to meet unfunded commitments, hedge fund investments are fully funded. Therefore, hedge funds are generally not as proactive in helping would-be sellers find buyers—particularly buyers that are not likely to support growth in the liquid side of their businesses.

**Process and Transparency**

A traditional private equity secondary transaction entails multiple rounds of bids organized by an intermediary with a well-populated data room and access to the sponsor. Once the winning bidder is determined, the closing mechanics are fairly uniform. Financing is typically available to the buyer, if desired. Buyers and sellers of illiquid funds in other alternative categories are not typically able to engage in the same process. Because of a combination of lack of size, motivation and secondary experience, information is not as readily accessible. Buyers with historical knowledge of the assets and an existing relationship with the asset manager are better-positioned to overcome this barrier to entry.

**Discounts Are Worth the Effort**

We believe that secondary investors should expand their focus beyond the well-trodden private equity secondary market. While traversing in undiscovered secondary markets has challenges, it can be rewarding. For buyers who are able to navigate this more opaque terrain and are willing to deploy less capital per

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**DISPLAY 3**

Private Debt Assets under Management and Forecast, 2010 – 2025

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opportunity, the discounts to NAV can be much greater. With equity valuations near all-time highs and meager fixed income yields, the higher discount to NAV can provide portfolios much-needed downside protection, shifting the driver of return toward liquidity provision versus growth in asset prices.

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