The Secondary Private Equity Market

Phil Niles discusses the developing secondary market and its benefits to both firms and investors

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One of the true hallmarks of the private equity industry up until the present has been its relative illiquidity. Indeed, there are few other instances where both the portfolio holdings as well as the investor's interests in the funds themselves lack marketability to such an extent. Up until fairly recently, even the concept of a secondary market for investments related to private equity was difficult to fathom, let alone to enact. However, with the maturation of the industry in general and the shifting desires of fund managers and investors, private equity is seeing a sharp increase in the opportunities for secondary transactions. And, most notably, this increase in liquidity is happening at both the firm level as well as the investor level. Though certainly the fallout of the credit crisis dampened the activity in this sphere, as it did in all other financial markets, it looks like secondary transactions are here to stay.

Secondary Buyouts

One of the prime examples of how greater liquidity is coming to the firm level is the emergence of a strong market for secondary buyouts. Historically, the exit paths for investments in private equity were minimal; they included an initial public offering, management buyout, etc. However, an emerging trend is the sale of private equity assets to other private equity firms. Prior to the market disturbances of the fall of 2008, the 21st century witnessed strong year over year increases in number and dollar volume of secondary transactions. For instance, in 2003 there were approximately $18 billion of secondary buyouts with 2004 improving further to $40 billion (Anson, 2006).

A detraction of this approach is the perception of oversupply in the private equity industry. The argument has been made by some that the emergence of secondary buyouts as an available exit strategy points to the idea that there is too much capital chasing too few deals. Rather than seeking new investments, private equity firms are simply deploying capital between one another in the form of secondary buyouts. While this argument might have had some merit, the upheaval of the last few years has reduced the total dollar amounts in the market place, which undoubtedly has lessened this impact. Also, the logic for the buyout may not be to simply make an investment in a single entity, but rather to augment an existing one. For instance, a strategy might be to purchase several private equity companies in the same industry and consolidate them into a larger, more dynamic entity. Through secondary buyouts, a private equity firm can create economies of scale and heighten growth in a targeted manner with existing companies, rather than building from the ground up.

Liquidity for Investors

Though undoubtedly there is greater liquidity at the firm level for private equity participants, far larger gains have been seen at the investor level. As mentioned, illiquidity was one of the hallmarks of private equity investment, much to the distaste of investors. While those in the industry recognize that the typical investment methodology of private equity requires long time horizons and, hence, long lockups, it can nonetheless be problematic for investors for any number of reasons. There are a multitude of explanations for why an investor may wish to liquidate a private equity holding and a few of these reasons are worth a closer look in the scope of the current discussion.

One reason to sell a private equity holding is a simple rebalancing of a portfolio. Over time, with the ebbs and flows of the capital markets, portfolios can stray from their intended mix and may require alteration. Active portfolio management indicates that when an asset becomes overweight in a portfolio, it should be sold in order to re-establish the optimal mix. Obviously, the opposite holds true should an asset become underweight in a total portfolio context and one would choose to buy under such a circumstance. Alternatively, an investor may wish to permanently increase or decrease the allocation to a certain asset or investment type, again requiring such a rebalance.

Also, quite plainly, an investor may require the cash value for an investment. The reasons why an investor needs the cash are of course nearly infinite; there may be a more compelling investment option presented to the investor or the investor may have an upcoming obligation that requires cash, such as one might find at a pension plan with prescribed obligations. In either case, or the countless others not mentioned, the investor requires the ability to liquidate the position in order to generate cash to meet a certain objective.

Obviously, without a secondary market, none of the above is possible for a private equity investor. However, recent years has seen the development of the secondary market to the point where the aforementioned investor needs can be better serviced. With a more developed pool of investors seeking private equity investments, it is easier for investors to sell stakes for the various reasons discussed above. Portfolios can be better rebalanced in a timely and effective manner, cash can be generated from private equity investments to fund current obligations, and investors can better control the risk profile of their investments from a portfolio perspective.

The Case for the Buyers

It is important to note that, in this discussion of the benefits to investors in the private equity industry of the increased secondary market, we have thus far studied the positive attributes from the point of view of the seller. However, there are many distinct advantages for the buyer of pre-existing private equity positions; some may even argue that the benefits to the buyer are as important as the benefits to the seller. Regardless of one's beliefs with respect to this argument, it is hard to debate the notion that buyers have also greatly gained in this movement to greater liquidity in the private equity market.

One major advantage for the buyer is the immediate diversification benefit and ability to springboard into a more mature private equity holding. If an investor were to simply make an investment in a brand new private equity offering, it would take some time for a true portfolio of companies to develop. Also, the investor would have to plan for the numerous capital calls that would come over the initial stages of the private equity partnership. However, investing in the secondary market would allow the investor to potentially skip the capital calls and dive straight into an established pool of companies with the corresponding diversification benefits.

Additionally, an investment through the secondary market may allow access to larger, more established managers and funds. The talented private equity managers are in high demand and it may be hard for a smaller or lesser known investor to get access to the true heavy hitters of the industry. So while investors may be shut out of the initial round of capital raising, the secondary market may allow access to the top tier funds in time. By establishing a relationship during the later stages of the fund, the investor may be given part of the first round of fund raising for the manager's next private equity endeavour.

Finally, an investor can better manage his or her portfolio through the purchase of secondary market private equity investments. Say an investor finds a given portfolio is concentrated in one vintage year and wishes to diversify into other vintage years. The secondary market would permit an investor to chart this course with success. Also, an investor may find the portfolio too concentrated in a particular industry, but still desires to maintain a given amount in private equity. Through a secondary market transaction, the investor can better control the industry allocations within the private equity mandate. Finally, if an investor with a shorter time horizon wishes to make a private equity investment, the investor can purchase an interest in a fund which is closer to the harvesting phase of the fund's lifecycle, thus gaining a shorter commitment while still gaining access to the private equity industry.

Conclusion

The maturation of the private equity industry, and really by extension the alternative investment industry in general, has led to the creation and development of the secondary market. Investments which were once considered completely illiquid have now become more marketable. While it would be a stretch, perhaps even a crime, to suggest these investments are now liquid, there are certainly new options available to the industry's players at both the firm and investor level. There are definite benefits to all parties, but it is the investors who likely will gain the most from this development, at least in the near future. The establishment of the secondary market is a necessary precursor to greater efficiency in the private equity sphere and hopefully will encourage increased numbers of investors to enter this realm with confidence. *