PitchBook

Secondaries Fund Strategy Overview

A review of the current global secondaries landscape

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Credits & Contact

Analysts

JAMES GELFER Senior Strategist
james.gelfer@pitchbook.com
DARREN KLEES Data Analyst II
darren.klees@pitchbook.com

Contact PitchBook

RESEARCH
reports@pitchbook.com

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Key takeaways

- Early in 4Q, **firms have closed 26 secondaries funds totaling $26.3 billion YTD, putting it slightly behind the recent record**. Although aggregate annual numbers remain strong, a recent slowdown in quarterly fundraising activity may be a sign the investors are finally pumping the brakes on making new commitments.
- The record-breaking fundraising of recent years has resulted in a significant buildup of dry powder; however, **current dry powder levels have been stable on a relative basis when accounting for the heightened pace of capital deployment**.
- Secondary funds in aggregate have produced positive net cash flows to LPs for several consecutive years. This, combined with the fact that many LPs are only beginning to explore secondaries funds, **suggest that the robust fundraising environment of recent years is primed to continue**.

Below is a snapshot of a data visualization of the current secondaries market—click here to view the full visualization.

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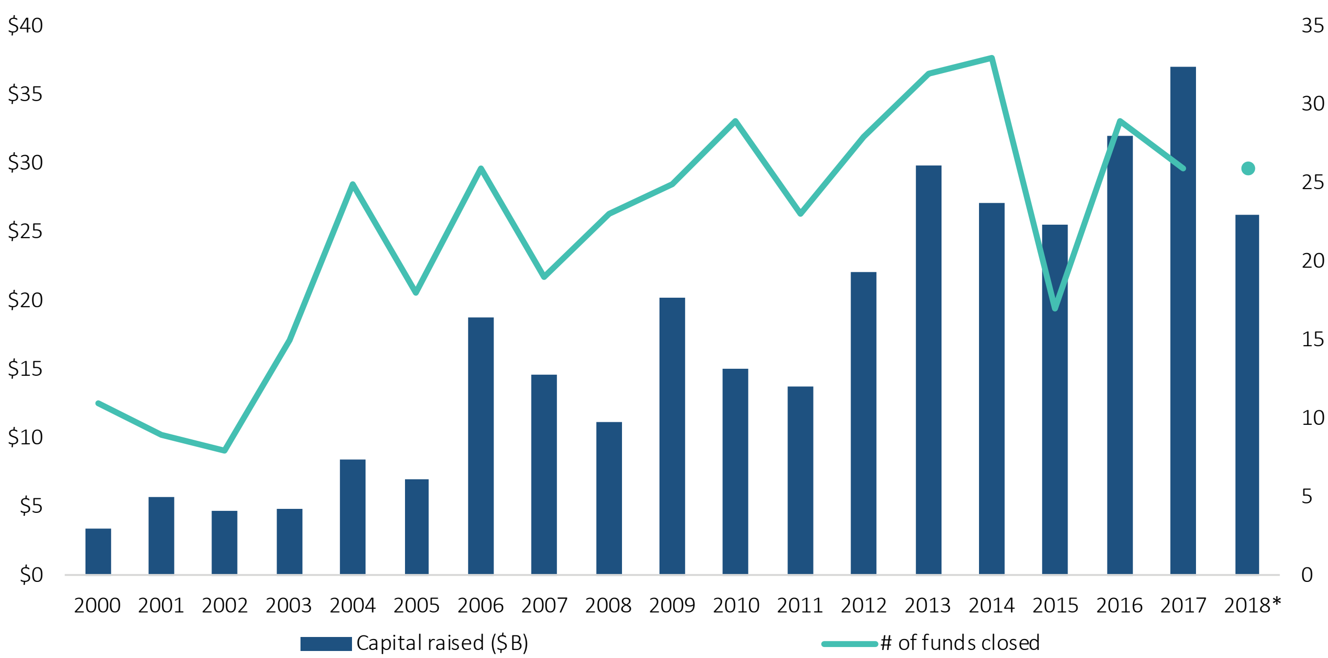
Overview

Coming off back-to-back all-time annual highs, secondaries fundraising has continued at a strong pace in 2018. Early in 4Q, firms have closed 26 secondaries funds totaling $26.3 billion year-to-date (YTD), putting it slightly behind the recent record. Whether fundraising in 2018 eclipses figures from 2017 largely hinges on if Lexington Partners will hold a final close on its ninth vehicle, which has a $12 billion target and has already held an initial close on $9 billion after being on the road less than six months.

Fundraising on track for another strong year

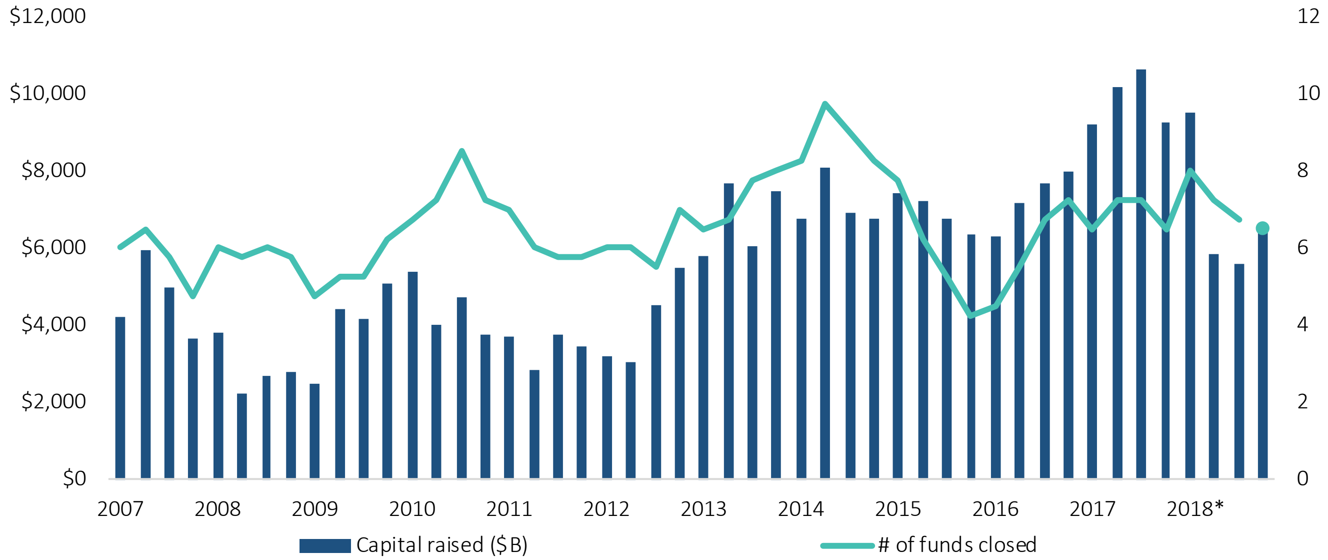
Global secondaries fundraising activity



Source: PitchBook
*As of October 31, 2018

Although aggregate annual numbers remain strong, a recent slowdown in quarterly fundraising activity may be a sign that investors are finally pumping the brakes on making new commitments. Quarterly fundraising is inherently lumpy, however, and this is particularly true for secondaries; in fact, 2Q 2017 ended up accounting for 54% of the yearly total. Another important factor is that many of the largest managers closed massive vehicles in the last two years, so 2018 has expectedly seen a downtick in mega-funds.

After several mega-funds closed in 2017, quarterly fundraising activity has cooled
Global secondaries fundraising four-quarter rolling average



Source: PitchBook
*As of October 31, 2018

With secondaries investment volume at record levels, however, that recently raised capital is quickly being put to work—which could lead to sustained strength in fundraising. Many of the largest managers, including Ardian and Coller Capital, are already back in the market with new multibillion-dollar offerings. Additionally, many established secondaries general partners (GPs) continue to expand into more niche areas with sector- or region-focused funds, which should sustain fundraising activity in the coming quarters.

Select open secondaries funds

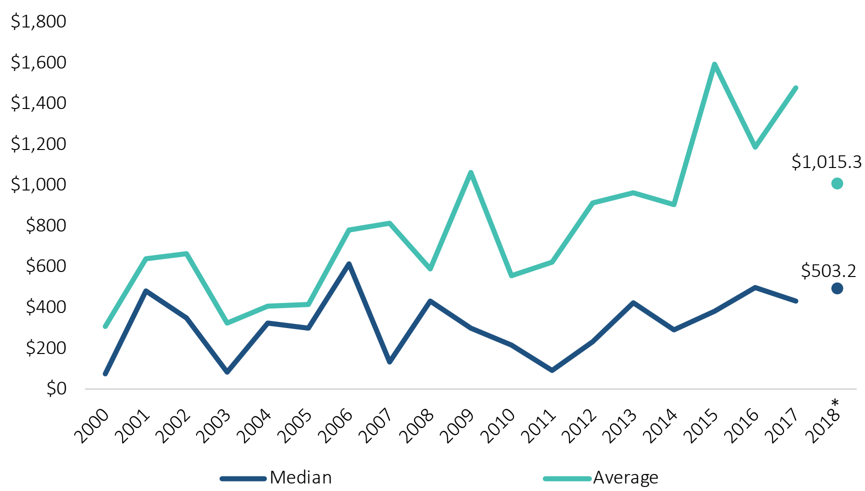
Investor	Fund name	Country	Fund family	Predecessor fund	Predecessor fund size ($M)	Predecessor IRR quartile
Ardian	Ardian Secondary Fund VIII	France	Ardian Secondary Fund (fka AXA)	Ardian Secondary Fund VII	$10,800	2nd
Lexington Partners	Lexington Capital Partners IX	US	Lexington Capital Partners	Lexington Capital Partners VIII	$10,100	2nd
Coller Capital	Coller International Partners VIII	UK	Coller International Partners	Coller International Partners VII	$7,150	3rd
Glendower Capital	Glendower Capital Secondary Opportunities Fund IV	UK	DB Secondary Opportunities Fund	DB Secondary Opportunities Fund III	$1,700	4th
Adams Street Partners	Adams Street Global Secondary Fund 6	US	Adams Street Global Opportunities Secondary Fund	Adams Street Global Secondary Fund 5	$1,054	1st

Source: PitchBook
*As of October 31, 2018

Relatively few newcomers have closed funds in 2018, but many of the vehicles being raised are smaller and focused on specific regions, sectors or types of secondaries transactions. Some examples include a vehicle from Schroder Adveq that is focused on mature secondaries, HQ Capital's Asia-based fund and an energy-focused fund from Ardian. While this has pulled down the average fund size, the secondaries industry continues to trend toward larger funds and transactions. To that end, the median fund size has continued its ascent and is now at the highest level in the last decade.

Despite a pullback in the average fund size, the median continues to climb

Median and average global secondaries fund size ($M)



Source: PitchBook
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Strategy evolution

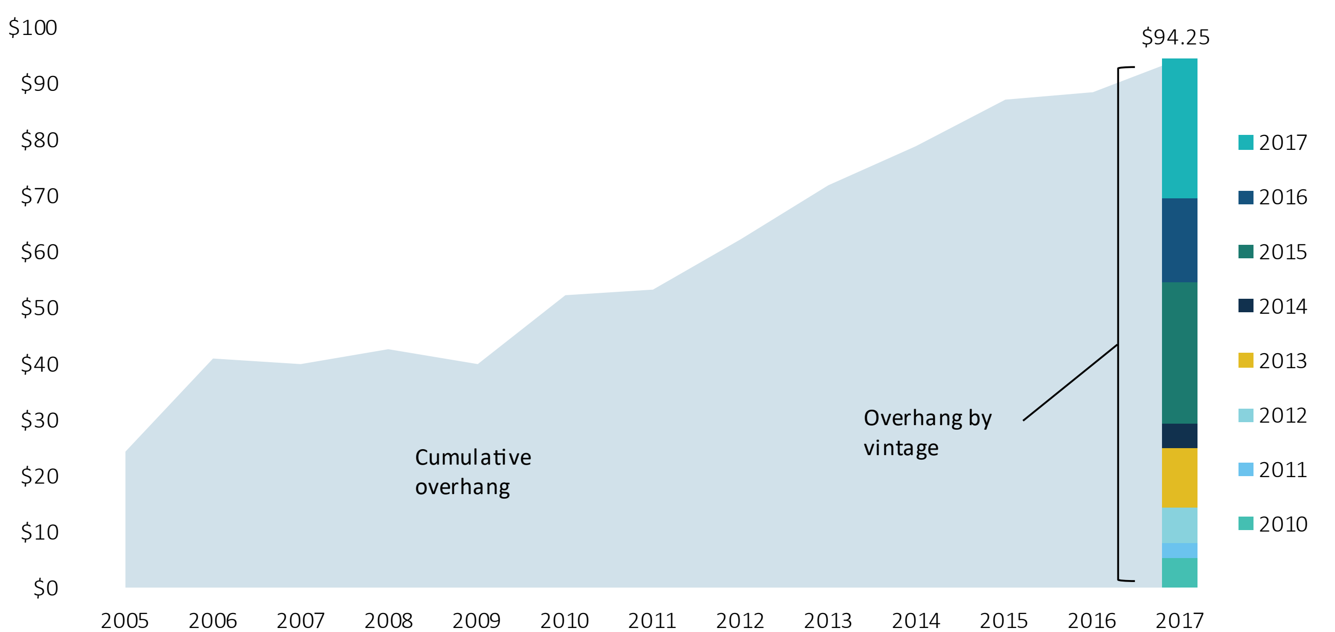
As the secondaries strategy has attracted more attention, alternative asset managers continue to seek out new ways to tap into the space. In addition to sector and region specialization, managers are looking to differentiate themselves through innovative deal sourcing and structuring. Whitehorse Liquidity Partners is a prime example. The Toronto-based firm, which was founded in 2015 by the former head of secondaries at Canada Pension Plan Investment Board, utilizes a unique preferred equity structure in its secondary transactions. After closing on more than $400 million in 2017 for its first fund, the firm has already concluded fundraising for a second vehicle that hit $1 billion. Some secondaries firms are capitalizing on the strategy's popularity to expand their operations. The management company of NewQuest, which has traditionally pursued primary buyouts and growth equity deals in Asia, received an equity investment from TPG Capital and will use the funding to expand its secondaries business. With the rising popularity of secondaries and a rapidly expanding cadre of GP stakes investors, we expect to see more of these deals in the future.

Sitting on a powder keg?

As more capital has flooded into the space, pricing for limited partner (LP) fund stakes on the secondaries market has risen to unprecedented levels. This has led some industry professionals to echo a common refrain in private capital markets: there's too much capital chasing too few deals. To be sure, the record-breaking fundraising of recent years has resulted in a significant buildup of dry powder.

Dry powder continues to build as the secondary market gains popularity

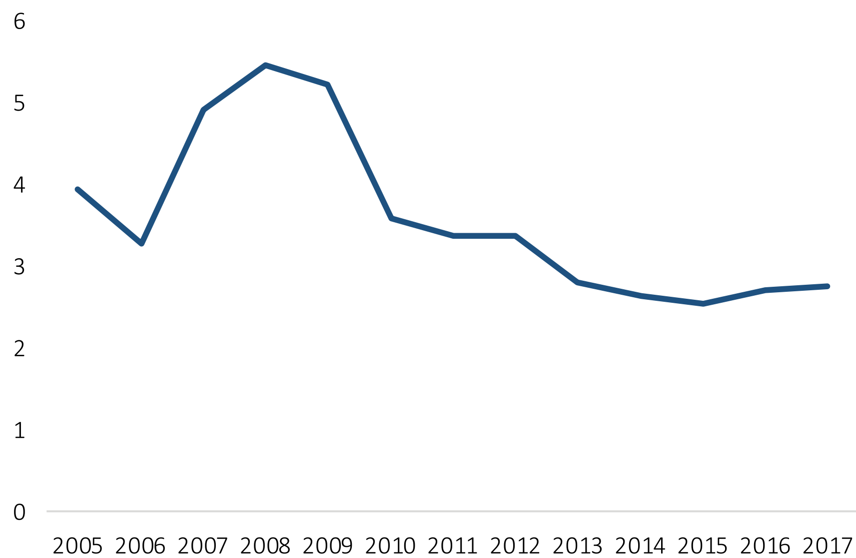
Global secondaries capital overhang ($B)



Source: PitchBook
*As of December 31, 2017

But instead of solely concentrating on the absolute level of dry powder, industry professionals should also consider the amount of available capital in relation to the current investment environment. To that end, when we examine the years of dry powder on hand (i.e. if fundraising ceased today, how long it would take secondaries funds to deploy all currently available capital), the present situation seems quite reasonable on a historical basis. In fact, this measure has not surpassed the three-year mark since 2012.

The pace of investment has kept up with the surge in fundraising
Years of global secondaries dry powder on hand



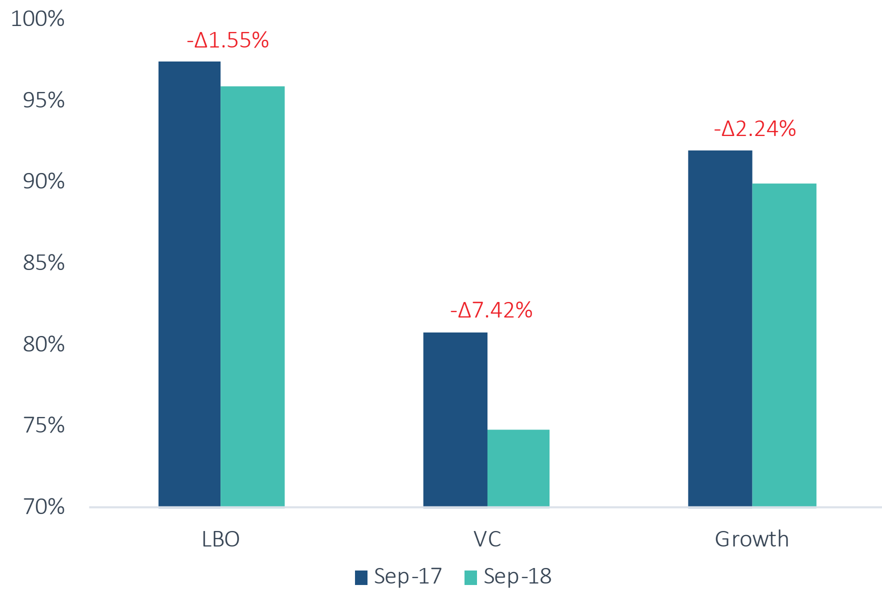
Source: PitchBook
*As of December 31, 2017

One confounding factor, however, is that secondaries funds recently have exhibited a propensity to use more leverage in transactions. Based on an analysis of 1,217 deals since 2013, Triago estimated that debt comprised 23% of capital spent on PE secondaries deals in 2017, compare to 19% in 2016 and only 4% in 2013. If this trend continues, it will translate to increased buying power for funds, which could change the dry powder arithmetic going forward.

Another important consideration when it comes to dry powder is deal sourcing. With the secondaries market maturing at a rapid pace and new players continuing to enter the space, we see ongoing innovation in deal sourcing and structuring. In 2018, this has been most evident in GP-led transactions, which have represented a sizable chunk of new deals in the market. GP-led transactions have traditionally been viewed with some skepticism, with the assumption being that the deals involved "zombie" funds from managers incapable of raising a new independent vehicle. But following successful transactions involving notable GPs, including BC Partners and Nordic Capital, several other name-brand GPs are reportedly exploring secondaries transactions.

Pricing falls in the secondary market

Secondaries pricing as % of NAV

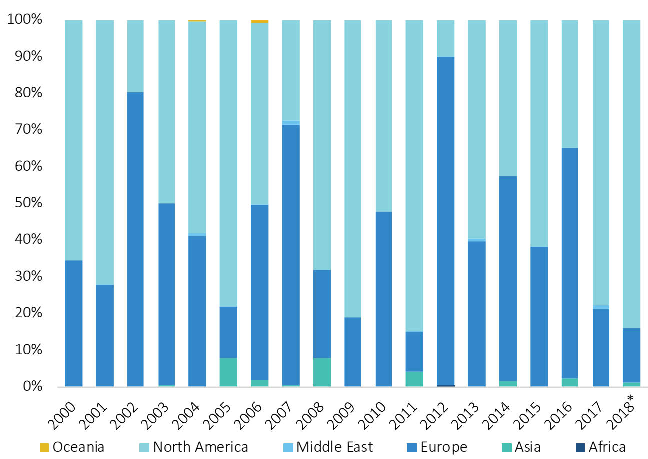


Source: Setter Capital
*As of September 30, 2018

Stapled secondaries deals have also been on the rise as the secondaries market in general has become less stigmatized. These deals take a variety of shapes and sizes—from helping to restructure a firm and relaunch under a new name, to complex transactions that bring together investments and LPs involved in disparate fund strategies overseen by a common GP. The potential conflicts of interest and legal hurdles can be a deterrent to stapled deals, but we think these transactions will be necessary as private markets continue to mature; GPs need options to streamline the end-of-life process for older funds, and LPs will benefit from mechanisms that provide options for managing their illiquid holdings.

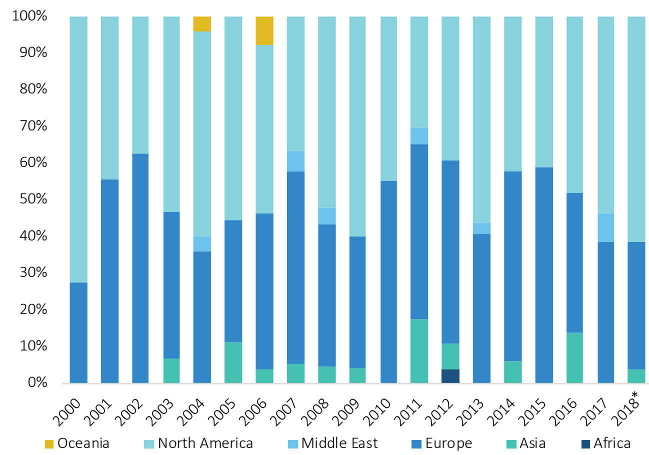
Fundraising update—size & region

Global secondaries fundraising ($) by region



Source: PitchBook
*As of October 31, 2018

Global secondaries fundraising (#) by region



Source: PitchBook
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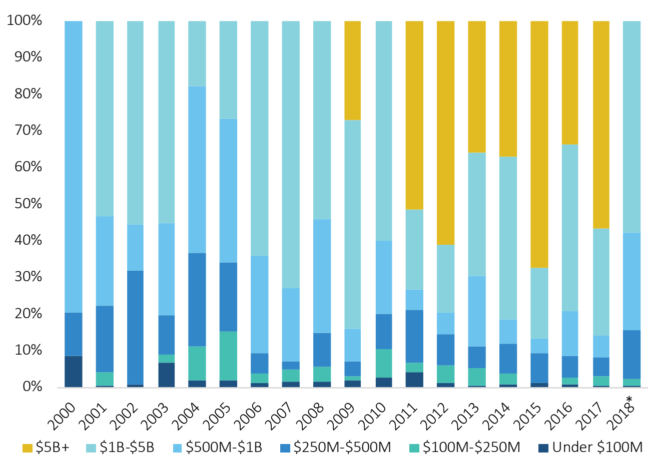
Global secondaries fundraising ($) by size



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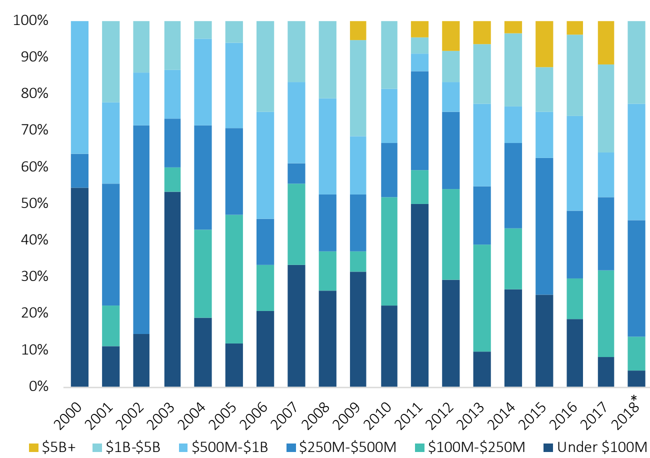
Global secondaries fundraising (#) by size



Source: PitchBook
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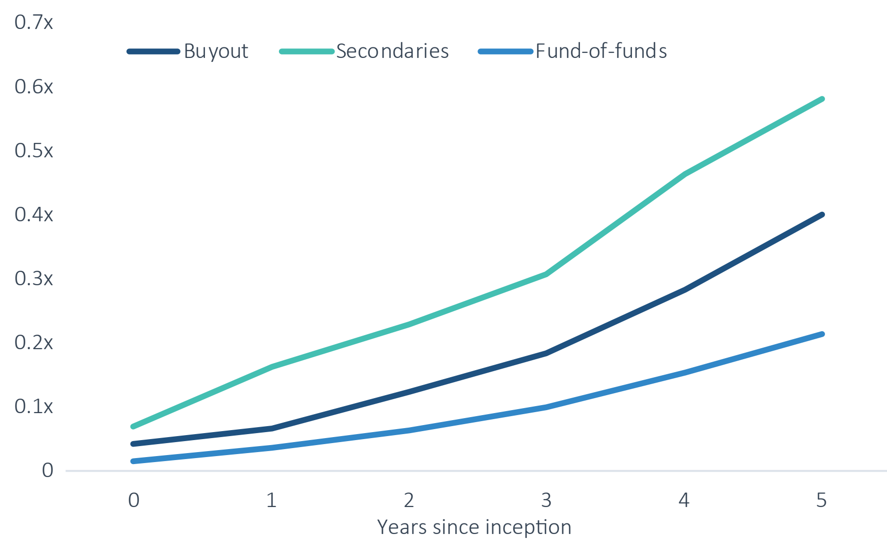
Fund performance & cash flows

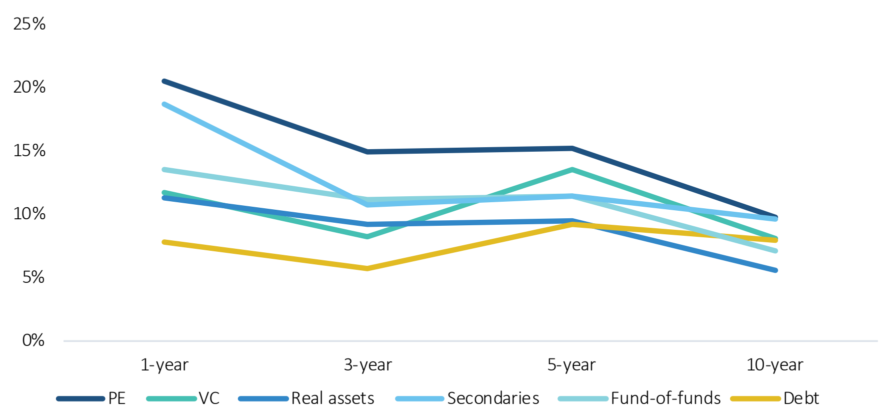
Most investors are familiar with the elevator pitch for secondaries funds—from J-curve mitigation to turnkey vintage year diversification. The data supports the J-curve mitigation narrative, and there are certainly portfolio construction reasons to allocate to secondaries. But beyond that, across most timeframes the strategy also performs well on both an absolute and relative basis to other private capital strategies.

Early distributions from secondaries funds help mitigate the J-curve
Average DPI multiple by strategy



Source: PitchBook
As of September 30, 2017

Secondaries boast strong performance across time horizons
Global horizon IRR by strategy



Source: PitchBook
As of December 31, 2017

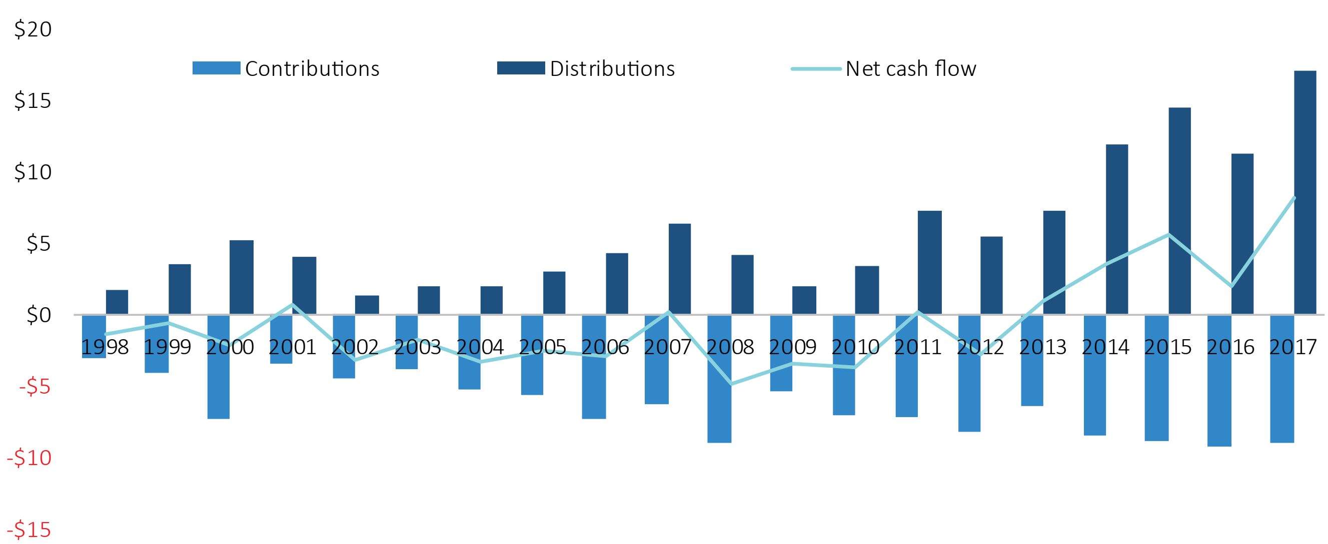
While historical returns are strong, heightened competition has sparked concerns that overall returns for secondaries funds will begin to fall for newer vintages. Despite the rich pricing in the secondaries market, investors have mixed views when it comes to revising downward their return expectations. Many investors have been lowering their return expectations, but they remain high on an absolute basis. A recent presentation prepared by Ardian shows, for example, that the firm is targeting a net TVPI of 1.6x and a net IRR of 16% for its latest offering, which is comparable to the performance of its prior vehicles.

Skepticism appears to be higher on the LP side. Florida Small Business Administration senior investment officer John Bradley recently said that "record pricing and increasing competition for deals has led us to lower our return expectations for our secondaries strategies.[1] However, this is not unique to secondaries." Indeed, primary investment vehicles, such as buyout and VC funds, have also experienced pricing pressures in recent years.

For now, secondaries funds in aggregate have produced positive net cash flows to LPs for several consecutive years, as has been the case for most private capital strategies. These positive cash flows, combined with the fact that many LPs are only beginning to explore secondaries funds, suggest that the robust fundraising environment of recent years is primed to continue.

Positive cash flows bode well for future secondaries fundraises

Global secondaries fund aggregate net cash flows ($B)



Source: PitchBook
As of December 31, 2017

1: "Secondaries special: Florida SBA lowers return expectations," Private Equity International, Adam Le, September 11, 2018