Growing Up: How the private equity secondary market has reached a new stage of maturity

Private equity secondary transactions are fast becoming a core pillar of the private equity market. The optionality provided by innovative buyers became even more prevalent and, some would say, crucial during the upheaval of the pandemic and this has revolutionised how private equity firms manage their assets.

Despite rapid growth in recent years, the private equity secondary market is still in a relatively nascent stage, but there are signs that there is much more to come.

Fundraising trends in the private equity secondary space

Fundraising activity in the private equity space is very strong, reflecting the robustness of the market in general. However, it is concentrated among a handful of well-established, large secondaries players. Private Equity International estimated the total raised by secondaries-dedicated funds in 2021 to be $51bn, down from $95.6bn in 2020, which in turn was nearly triple the $33.1bn raised in 2019. This cyclicality is due to the dominance of a handful of well-established managers: in 2020 Ardian's ASF VIII, Lexington Capital Partners IX, Goldman Sachs Vintage Fund VIII and AlpInvest Secondaries Program VII raised $53.5bn between them, more that the total market the following year.

This year is set to be another bumper year for secondaries fundraising according to industry publications. Ardian's ASF Fund IX is targeting $15bn, HarbourVest's Dover Street XI is aiming for $13.5bn, and Blackstone Strategic Partners is targeting $20bn.

Dealflow opportunities and growth

The growing importance of the private equity secondary space is reflected in the scale of the market, with 2021 seeing record transaction volumes. Whilst fundraising remains robust, the market is investing as fast as it can raise, with dry powder estimated to be just one year of transaction value. This emphasises how big the secondaries market can become, with supply of capital seemingly setting an upper limit of annual deal value.

Problem-solving through GP-led deals

GP-led secondary transactions (processes initiated by the manager which vary in complexity from replacing some LP interests in an existing fund to rolling one or more assets into a continuation vehicle) have shed their image as a last resort for struggling managers. With their adoption by several top-tier high quality GPs over the last few years there is now a level of acceptance in the market. Dislocations caused by the pandemic prompted managers to explore options to give portfolio companies more time to execute business plans via the secondaries market. This was a contributing factor to the $68bn in global transaction volume in GP-led deals in 2021, more than double that of 2020.

Continuation vehicles and single-asset funds are increasingly seen as viable exit routes. They give managers optionality for strong assets in funds coming to the end of their lives and allow LPs to precisely manage exposure to specific managers or assets. Given this, GP-led transactions are likely to continue to drive growth in the secondaries market.

A rebound in LP-led deals

LP-led secondary transactions (whereby one or more LPs sell their interests in an underlying fund to a secondary manager) have over recent years formed a smaller percentage of the market than GP-led deals. In 2021, however, the total value of LP-led deals reached $63bn. This is more than double that of 2020 and just under half of the total secondaries market for the year. This rebound is, in part, due to the desire of some LPs to actively manage their alternatives portfolio and crystalise gains. It also reflects the appetite for private markets from institutional investors with little or no current allocation. Secondaries are seen by these LPs as a way to fast-track building a PE portfolio, and as one that mitigates the J-curve effect and provides visibility on underlying assets.

This increase in volume was accompanied by a rise in pricing, with more than half of these deals reported to be priced at a 5% discount to NAV or better, double the number of deals priced in this range in 2020.

Key developments: younger assets, mergers & acquisitions, new asset classes

Interestingly, secondaries advisor Campbell Lutyens reported in its 2022 Secondary Market Overview that more than 50% of the volume of LP-led transactions involved fund vintages that were less than six years old. 70% of GP-led transaction volume involved companies held for six years or less. This trend is due to the breakneck pace of capital deployment in recent years, which has seen the NAV of younger funds growing rapidly and presented the opportunity for secondaries buyers to generate higher multiples on investment by acquiring portfolios earlier. These attractive multiples, traditionally lower for secondaries investments due to the more mature assets they acquire, may entice a broader LP base into the asset class and turbo-boost fundraising.

Recent M&A activity involving secondaries firms reinforces the potential for the market to grow significantly. Last year there were at least nine deals involving buy-side secondaries firms. In September, CVC announced that it acquired Glendower Capital, the UK-based secondaries firm that span out of Deutsche Bank in 2017, asset manager Franklin Templeton completed its acquisition of secondaries stalwart Lexington Partners in April, and Ares similarly acquired Landmark Partners in June last year. Where some brand-name GPs are acquiring secondaries capabilities, others are building out teams internally to gain a foothold in the market. These deals represent a validation of the secondaries space and a confirmation that it will become an ever-present aspect of the private equity market.

With private equity secondaries firmly established, managers are branching out into new asset classes, with private credit a significant growth opportunity. Secondaries pioneer Coller Capital closed its $1.4bn Coller Credit Opportunities I fund earlier this year, its first vehicle dedicated to private credit secondaries. This raise underlines LP appetite for the strategy, as its initial target was $750m. With the private credit space in rude health, it seems a natural step for its secondaries market to expand in lockstep.

The road ahead

While the secondaries market has matured rapidly, there is still a lot of room for it to continue growing.

Dry powder in the market roughly equates to less than one years' transaction volume, indicating that supply of capital is a limiting factor in the growth of secondaries.

On the transactions side of the market, GP-led deals have surged in recent years as top-tier sponsors have engaged in transactions and the market sees these deals as increasingly acceptable. In a recent podcast, Coller Capital noted that roughly fifty percent of top-tier managers are yet to engage in a GP-led process, again indicating that the growth opportunity is significant.

Combined with the rise of funds dedicated to secondaries in other private asset classes, the secondaries market is set to cement its place as an essential element of the private markets space.