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# How is the secondaries market evolving?

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Secondaries have come a long way from their humble beginnings in the 1980s, when they were largely perceived as a way of exiting illiquid positions in private equity funds. Two decades later, secondaries are a multibillion dollar market and an established portfolio management tool. Every type of private equity investor now uses them, and new products and investment strategies are evolving to meet the demands of a more sophisticated audience.

The market has been rising fast: the $10bn traded last year compares with a mere $6.7bn in 2005, and in 2007 it is expected to reach as much as $15bn. Of the wide range of factors fuelling this growth, the principal drivers are the growing range and type of deals traded and a significant increase in the seller base.

Though it's hard to believe now, secondaries used to be perceived as somewhat exotic. But as sellers came to realise the benefits of secondaries as a portfolio management tool in the early 00s, the market began to really take off, leaping from $1.9bn in 2002 to $5bn in 2003. Using secondaries to re-up to existing funds or reallocate capital to other funds or asset classes is now the norm.

The dramatic increase in LP allocations to private equity as a whole testifies to the popularity of the asset class; and the liquidity offered by secondaries is helping to stimulate that appetite still further. As allocations have grown, some LPs have found themselves encumbered with portfolios that are too diverse or partly underperforming. Being able to select individual investments to sell to secondaries players has helped them rationalise their portfolios and make larger commitments to a smaller number of GPs; it has also added to secondaries deal volume.

In a survey by Almeida Capital in March 2007, 83% of LPs had bought, or intended to buy a secondary interest in a fund or portfolio of companies. Given that the vast majority of private equity investors are now also secondaries sellers, one might be forgiven for thinking the market is close to reaching saturation. But secondaries are increasingly attracting investment in their own right - as the amount of capital targeting secondary firms' funds in the last two years demonstrates.

Investors looking to commit larger sums to private equity are using secondary funds to supplement their primary fund commitments and augment their overall exposure. Strong investor demand enabled Greenpark Capital to close our third fund at €730m, well in excess of our €500m target, and secondaries operators have raised unprecedented sums in recent years. According to Private Equity Intelligence, $10bn was raised by 16 funds in 2006, with funds closing on average 28% over their original target. By mid-April 2007 six funds had already raised $10.5bn, and there were a further 10 funds seeking a total of $8bn. Commentators are predicting that $15-18bn will be raised this year.

As the market matures, the range of products being traded in the secondaries market is expanding. In addition to traditional secondaries transactions such as LP partnership interests in buyout and venture portfolios and auctioned assets, competition for assets and correspondingly punchy pricing is leading to more complex proprietary transactions and direct secondaries being done. We're seeing newer products such as stapled primary-cum-secondary transactions, where a captive or semi-captive private equity investment team spins out of its parent company.

With increased liquidity, smaller deals are also now commonplace. Where previously sellers would look to exit whole portfolios, now they can exit individual investments with transaction values as low as $5m. Secondaries are no longer all-cash transactions, with structuring becoming a regular feature. With structuring, agreement is reached with the seller about the purchase price, with delayed payments, or with the seller retaining partial exposure to the portfolio. Structuring can also be buyer-driven, involving special purpose vehicles, leverage or vendor asset swaps. The use of leverage, in particular, is rising. The motto seems to be that whatever a seller's liquidity requirements, there's a secondaries solution that can meet them.

Over the last 18 months to two years competition for plain vanilla, larger and auctioned deals has been intense and as secondary prices have correspondingly risen significantly. Nearly all secondaries were sold at a discount two years ago, with venture deals at a high discount; today many bids are at par, with premiums paid for higher quality assets. Average premiums for larger auctioned assets were 9% in 2006, compared with discounts of 5-6% in 2005. In addition, leverage in some underlying assets is higher than a couple of years ago and therefore portfolio risk has risen.

Nevertheless in some areas there is far less competition, and these are likely to be the focus for specialist operators in the next couple of years. Smaller to mid-size, more complex deals, in Europe in particular (where auctions are less common) are still being sold at a discount, and that is Greenpark Capital's specialist area.

The question on everyone's lips is what impact the end of the cycle of cheap debt / record private equity transactions will have on secondaries. Naturally there are doom mongers predicting catastrophe on the grounds that people who are overpaying for assets now are likely to have to sell at a loss, as happened in the late 90s. With pricing, leverage and risk all rising, it does seem certain that, as in the primary market, average returns would be likely to fall.

But as in the primary market, top quartile funds may maintain more constant returns. Returns don't automatically fall in line with downturns in economic cycles. They are expected to fall far less in the more customised part of the market, and average returns are still predicted to outperform other markets.

The extraordinary returns that secondaries have enjoyed in the last couple of years are unlikely to be sustained over the next few years – particularly for the larger, auctioned deals. But even these are still likely to be higher than public market or hedge fund returns, and that explains why LPs are still investing heavily in private equity. The outlook for the secondaries market is very positive, and Europe in particular should provide significant dealflow in the next few years.

Given the amount of primary private equity funds being raised, and strong demand from both GPs and LPs for liquidity, the secondaries market could well achieve predictions of $15bn this year. Of the pool of private equity capital raised in the last eight to ten years, with as little as 1-2% going to secondaries each year the market would reach $15bn – and that does not even include the portfolios of direct investments coming from corporate sellers.

In addition, as happened in 2001-2002 when large numbers of unfunded positions poured on to the market, any economic downturn is likely to simply increase the supply of assets coming on to the secondaries market and lower prices. Naturally there is a risk that a downturn could, after an initial uplift, lead to a contraction in the primary market that has a knock-on effect on secondaries, both in terms of the supply of assets and investor appetite for new funds. Secondaries might even struggle to invest the vast sums that have been raised in the last two to three years.

But this scenario is a long way off. With secondaries increasingly being viewed as interchangeable with primary investments, investors will continue to include secondaries among their private equity portfolio. The market has come of age.