INVESTMENT INSIGHTS

The secondary market for private equity

Investment characteristics and market outlook

September 2015

IN BRIEF

Given supply/demand dynamics and the continued maturation of the market, we believe the outlook for private equity (PE) secondaries remains attractive for opportunistic investors, despite an increasingly competitive pricing environment.

• The secondary market broadens the opportunity set for private equity investors, offering liquidity and providing a tool for rebalancing and diversifying portfolios.

• Shorter holding periods, greater transparency and a quicker return of capital are some of the potential benefits of PE secondary (vs. primary) investments.

• As the secondary market has matured, the seller universe has diversified to include a more robust and varied array of entities, a trend that we believe will benefit buyers and is likely to continue in the coming years.

• Investment success in the secondary PE market requires meaningful relationships with agents and general partners (GPs), skill and experience in evaluating investments, and the integrated resources required for a nimble response to secondary market opportunities.

THE SECONDARY PRIVATE EQUITY MARKET—WHERE PRE-EXISTING PRIVATE EQUITY INTERESTS ARE BOUGHT AND SOLD—HAS GROWN SUBSTANTIALLY SINCE ITS BEGINNINGS IN THE 1980s.

With transaction volume reaching $42 billion in 2014, the secondary private equity market continues to mature in its diversity of participants and complexity of transactions. It is no longer merely a market for distressed sellers. Today pension plans, endowments and foundations, family offices, asset managers, financial institutions, sovereign wealth funds and GPs alike are among its many participants—acting as both buyers and sellers.

This report defines the characteristics of secondary private equity investing and examines secondary market dynamics and trends, along with their implications for investors. Additionally, it offers a perspective on the market over the next few years and suggests key considerations for investors interested in participating in the secondary market’s expanding investment opportunities.

FOR MORE INFORMATION

Please contact your local J.P. Morgan Asset Management or Private Equity Group Representative with any questions, or email PEG_Questions@jpmorgan.com

1 Cogent, Secondary Market Trends & Outlook, January 2015.
DISTINGUISHING CHARACTERISTICS OF SECONDARY PRIVATE EQUITY INVESTMENTS

Private equity investors may choose to sell their PE interests for a variety of reasons: to raise cash or obtain relief from future capital calls, trim overall PE exposure, fine-tune PE portfolio composition and/or address regulatory concerns.

The growth of the secondary private equity market is a testament to its potential advantages for buyers as well as sellers. A secondary market transaction transfers a direct company or limited partnership (LP) interest in a private equity fund (i.e., in the fund’s existing portfolio companies, as well as unfunded commitments) from the seller to the buyer. As such, the secondary market can be used as a supplement to the primary market in building out and managing private equity holdings. The distinct characteristics and potential benefits of secondary private equity investments include:

Diversification
The secondary market can offer investors an opportunity to diversify private equity holdings across vintage years, geographies and sectors—perhaps providing access to GPs not currently represented in their portfolios.

Greater transparency
Since secondary investments often involve funds in which a significant level of capital has already been invested, there is less “blind pool” risk; existing portfolio companies can be evaluated, and there are fewer unfunded commitments.

Potential mitigation of the J-curve effect
The J-curve is a well-known concept among private equity investors, describing the general pattern of returns for a successful primary market private equity investment: moderately negative returns in the early years (when fees and expenses are high relative to invested capital), increasing returns as earnings and valuations grow (with meaningful distributions beginning around year three and cash flows usually turning positive around year seven), followed by the harvesting stage, in which asset sales and distributions continue until the end of the investment term (usually 12 years). Investors in private equity secondaries typically purchase interests midway through the investment’s life cycle, as shown in EXHIBIT 1, often paying a large up-front purchase price, but avoiding fees and expenses paid in the initial years, which generally result in early negative returns for primary investors. Additionally, if the assets are purchased at a discount in the secondary market, investors may experience an early unrealized positive return when the assets are written up to current value.

Secondary private equity investing involves an up-front purchase price but can help investors avoid some early years of negative return

EXHIBIT 1: ILLUSTRATIVE ANNUAL CASH FLOWS FOR A PRIVATE EQUITY PARTNERSHIP

Accelerated return of cash
With a later-stage start, secondary private equity investments typically exhibit shorter holding periods and a faster return of capital than primary partnership investments. Of course, the timing and magnitude of cash flows will depend on the stage of life in which the secondary investment is made, as well as the quality and characteristics of the underlying private equity companies.

HISTORICAL MARKET DYNAMICS AND TRENDS
One of the key factors in successful secondary private equity investing is an understanding of market trends and underlying forces. Due to the long-term and illiquid nature of private investing, secondary interests are often sold and purchased at discounts to net asset value (NAV). In addition to the quality of the assets for sale, the average amount that these interests are discounted depends in part on the supply and demand dynamics at play.

2 The net asset value (NAV) is the market value of the company or remaining investments in the fund.
Public equity performance is a driver of private equity investment

EXHIBIT 2: PRIVATE EQUITY FUNDRAISING RELATIVE TO PUBLIC EQUITY PERFORMANCE

On the demand side, increasing private equity fundraising is typically associated with a positive public equity market, as demonstrated in EXHIBIT 2. The rise in investors' public equity holdings may lead them to feel under-allocated in private equity as a percentage of their total portfolios, necessitating larger commitments to private equity. Additionally, positive public equity markets are often correlated with a good exit environment and therefore strong distributions for private equity investors. During these market environments, investors increase commitments as a means of reinvesting distributed capital in the private markets. As a result, the demand for private equity across all investment types, including secondary investments, generally increases in tandem with public market appreciation.

On the supply side, the response of sellers of private equity interests on the secondary market to public equity performance is more nuanced. Sales can be motivated by different factors during different market environments, as depicted historically in EXHIBIT 3.

- In 2008 and 2009, with the decline of public equity markets, private equity investors became over-allocated, a phenomenon known as the denominator effect, and distressed investors sold private equity interests in order to generate liquidity. At the same time, the decline in demand for private equity resulted in steep discounts for transacted deals.

- As the markets recovered, investors’ liquidity issues lessened and sellers were able to be more strategic in terms of which assets to sell, using the secondary market as a means for portfolio management. As demand for private equity rose in tandem with the public markets, both secondary transaction volume and pricing increased from their lows.

Distressed selling, propelled by the equity market downturn in 2008–09, gave way to selling driven by regulatory issues and portfolio management needs as the market recovered

EXHIBIT 3: SECONDARY TRANSACTION VOLUME AND SELLER MOTIVATION

*Represents purchase price proceeds plus unfunded relief for executed deals.

Along with market recovery, new regulations put in place—including the Volcker rule and capital ratio guidance under Basel III—have led financial institutions to sell private equity portfolios.

In recent years, GPs have been using the secondary market more regularly as a way to restructure their funds, particularly for tail-end portfolios. In short, since the market downturn, investors have increased demand, pushing secondary market prices steadily higher. Sellers have responded in kind, increasing supply—not in an effort to repair liquidity but, rather, primarily for portfolio management purposes. This has included selling tail-end portfolios, reducing the administrative burden of a large number of funds, and paring back non-core managers.

The secondary market is becoming more diversified as buyers and sellers expand their participation. Secondary transaction volume rose by over 50% year-over-year in 2014, a significant increase relative to the moderate growth in the earlier years following the market’s rebound. While we anticipate strong transaction volume in the coming years, we expect flat to moderate growth after the high of 2014. Sellers of secondary interests have become more diverse, shifting away from a market dominated by pension plans and financial institutions, as demonstrated in Exhibit 4. Though financial institutions still represented a large portion of transaction volume in 2014, we expect their participation to decline further. This is in part due to an extension provided by the Federal Reserve allowing U.S. financial institutions to delay, likely until July 2017, conformance with a provision of the Volcker rule that limits their holdings of certain private equity investments. We see this engendering a wait-and-see mentality on the part of some institutions regarding additional portfolio sales. We also expect that the upward trend in the use of the secondary market as a portfolio management tool will result in the continued diversification of sellers, as well as the diversification of assets being sold.

Likewise, the universe of buyers has also diversified, from traditional purchasers (i.e., secondary fund managers) to a more diverse array of entrants who recognize the benefits of secondary investing in managing their own portfolios, namely: gaining access to new managers, mitigating the J-curve and accelerating distributions. Pension funds, insurance companies, asset managers and endowments and foundations, as shown in Exhibit 5 (next page), are among the growing list of non-traditional purchasers that likely represent at least 20% of the secondary buyer universe.

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3 The term “tail-end portfolio” typically refers to the remaining assets in a private equity fund that is approaching or has exceeded its anticipated life. A tail-end transaction allows the manager of the fund to achieve liquidity for the fund’s investors.
The diversification of buyers and the positive trend in public equity performance have resulted in increased demand for private equity secondary interests. Additionally, low interest rates and the availability of leverage have further increased the potential capital available for secondary deals. Cogent estimates a potential $84 billion in near-term capital available to deploy in secondary transactions, roughly twice last year’s total transaction volume. Thus, the competition for secondary deals is strong and prices are likely to remain high—at single digit discounts of NAV, on average, including purchases at par or greater on the high end of the market. Despite availability of transactions, purchasers will face increased pressure to find high quality secondary deals, underwrite underlying companies at desired return targets under various potential future market scenarios, and purchase portfolios at prices resulting in attractive risk-return characteristics.

EXHIBIT 5: BREAKDOWN OF NON-TRADITIONAL SECONDARY MARKET BUYERS


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KEY CONSIDERATIONS FOR INVESTORS IN SECONDARY PRIVATE EQUITY INVESTMENTS

Institutional investors looking to expand and/or diversify their private equity holdings are increasingly widening their search to include secondary private equity investments. This is in response to the characteristically shorter holding periods, greater transparency and quicker return of capital for secondary vs. primary PE investments.

While market dynamics may suggest the continued availability of attractive secondary private equity investment opportunities over the near term, the market is likely to remain competitive. Institutional investors may choose to access the secondary private equity market on their own, with the help of an advisor and/or through a secondary market fund. Whatever the chosen route, generating attractive returns ultimately requires relationships and reputation, skill and experience, and the integrated resources to support seamless implementation.

Relationships and reputation

Meaningful relationships with agents in the marketplace and a solid network of GPs are key to sourcing attractive secondary market opportunities. In most cases, a transfer of interest in a fund by one LP to another requires consent from the GP. General partners typically prefer LPs who know their investment philosophies, understand how they add value to portfolio companies and have proven to be dependable sources for their primary capital fundraising. Particularly in a competitive secondary market environment, the payoff to relationship building may be the avoidance of bidding wars at large auctions that can drive up secondary market pricing.

Skill and experience

Purchasing private equity interests in the secondary market, even at a discount, does not necessarily translate into a successful and profitable investment. In addition to knowing and being known by private equity fund managers, an astute, disciplined approach to due diligence, strong underwriting standards and a forward-looking evaluation of the underlying portfolio companies are essential. The last point is particularly true when investing in private equity funds in the secondary market, since these funds generally have an existing portfolio of companies.

Integrated resources supporting seamless implementation

Institutional investors must also be nimble. This means having the capital and liquidity, legal resources, flexible investment guidelines, streamlined decision-making processes and transaction capabilities to act quickly and decisively when attractive secondary market investments are identified.
INCREASINGLY MATURE, INCREASINGLY COMPETITIVE

The secondary market has much to offer both buyers and sellers of PE investments. As such, we expect the market to continue to mature, diversify and deepen. Planned fundraising by secondary private equity funds and other PE buyers should contribute to an increasing demand for secondary investments, which could keep the pricing environment competitive even as transaction volumes expand. In a competitive market, investors will face challenges in their efforts to find and invest in high quality secondary deals with the potential for return enhancement. In our view, the critical factors for successful secondary private equity investing include an opportunistic approach to this supply/demand-driven market, knowledge of its participants, long-standing GP relationships and the ability to quickly evaluate and act on opportunities as they arise.

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