The Benefits of Secondary Funds in a Private Equity Portfolio

By Ryan Cotton
Senior Private Markets Research Analyst
CTC Consulting

While private equity serves as a compelling addition to a well-structured portfolio, it presents investors with unique challenges in the areas of cash flow management, diversification and liquidity. Implementing private equity secondary funds can help offset some of these challenges while presenting investors with favorable return characteristics.

INTRODUCTION

Private equity is an asset class utilized for its combination of diversification effect and return potential. Yet the construction and maintenance of a private equity portfolio can be challenging for both new and mature portfolios alike. Private equity investors must contend with unique mechanical complexities not often found in public market counterparts. High minimums, illiquidity, the "j-curve" effect, maintenance of sufficient exposure, and diversification management, all add a layer of portfolio management intricacy to the asset class. While largely unavoidable, there are ways to minimize the impact of these complexities without completely sacrificing the performance and diversification objectives investors seek with private equity investment. The deployment of secondary funds within a portfolio is one method of dampening these challenges.

Secondary investments – the purchase of existing partnership interests in private fund vehicles – benefit investors by providing:

- Blind pool risk mitigation
- J-curve mitigation
- Immediate exposure and diversification (strategy and vintage year)
- Accelerated cash flows

Further, these characteristics have historically come at a risk/return profile that compares favorably with the broader private equity asset class.

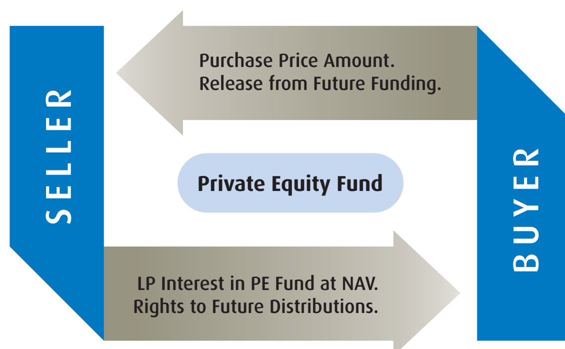
This paper explores the benefits of maintaining exposure to secondary investments via funds targeting this sub-sector of the private equity market.

BASIC TRANSACTION STRUCTURE

For investors not familiar with the strategy, it may be helpful to examine the basic mechanics behind a secondary transaction.

At the most fundamental level, secondary transactions involve the sale and transfer of an existing limited partnership interest in a private equity fund, or a portfolio of funds, from one investor to another. As a result, sellers receive liquidity for their stake in the investment and are released from any unfunded portion of their capital commitment. The buyer agrees to pay a predetermined price for the interest, often at a discount to Net Asset Value (NAV). By so doing, the buyer agrees to take on future funding obligations in exchange for future distributions from the investment.

FIGURE 1: A BASIC SECONDARY TRANSACTION



What prompts these transactions? Seller motivations can vary, ranging from financial distress to proactive portfolio management. Buyer motivations are, not surprisingly, typically centered on financial gain. But they can also involve the desire for access to a particular strategy, geography, fund vehicle or investment manager.

It is important to note that in almost all situations a secondary sale requires the consent of the fund's General Partner. This can prove advantageous for a buyer with strong private equity manager relationships. Maintaining a favorable relationship with the fund's management team can provide insight on key portfolio company details regarding operational performance and valuation potential. This information, which may be anecdotal and readily available to all potential buyers, can prove critical as the buyer forms a basis for offering price.

The most basic – and common – type of secondary transaction involves the sale of a limited partnership interest in a single private equity fund. However, transaction characteristics can take on more complex structures involving portfolios of funds, general partnership interests, direct investments and structured or deferred payment arrangements. For purposes of this paper, the focus is on the basic structure, though many of the same principles apply regardless of complexity.

While some private equity investors purchase secondary interests directly, many choose to access the strategy via secondary funds. These managed pools of capital target a variety of secondary deal profiles and allow investors to outsource the structuring and administrative burden of implementing a secondary portfolio. Again, for purposes of this paper, the focus of discussion will be on the utilization of dedicated secondary funds within a private equity portfolio.

PRIMARY BENEFITS OF SECONDARY INVESTMENT

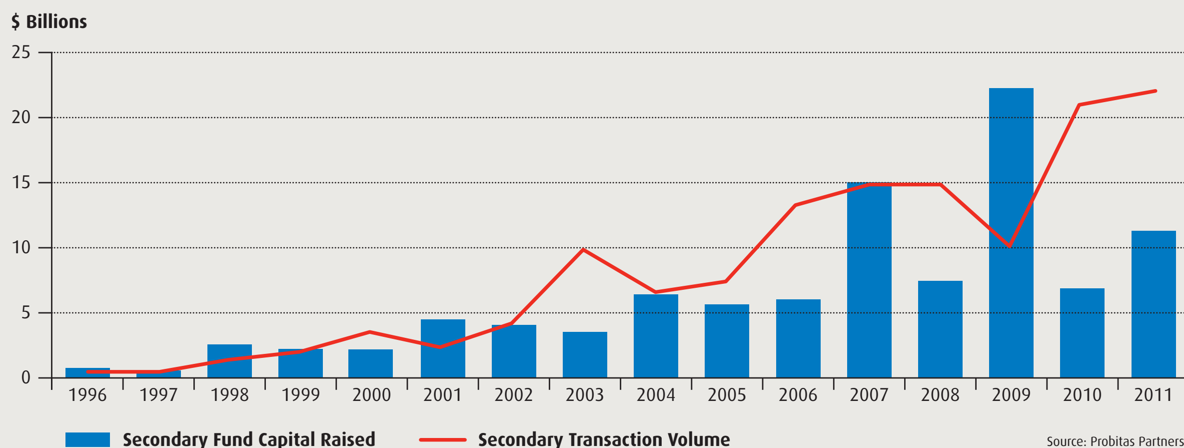
With the basic overview of secondary transactions covered, the strategy's benefits are explored below.

Reduction of Blind Pool Risk

Secondary funds reduce "blind pool" risk by investing in pre-identified, underlying assets. In contrast to primary funds, in which investors commit capital to a "to-be-assembled" portfolio, secondary funds invest in existing assets by purchasing mature underlying fund interests. These fund interests – typically at least 50% of committed capital called – contain identifiable and "underwriteable" portfolio company holdings. Acquiring a fund well into – or even beyond – its typical three- to five-year investment period allows the buyer to perform a comprehensive analysis of the embedded performance and future value potential of these underlying companies. Thus, portfolio risk is more readily identified by the secondary fund and can be priced accordingly into the transaction.

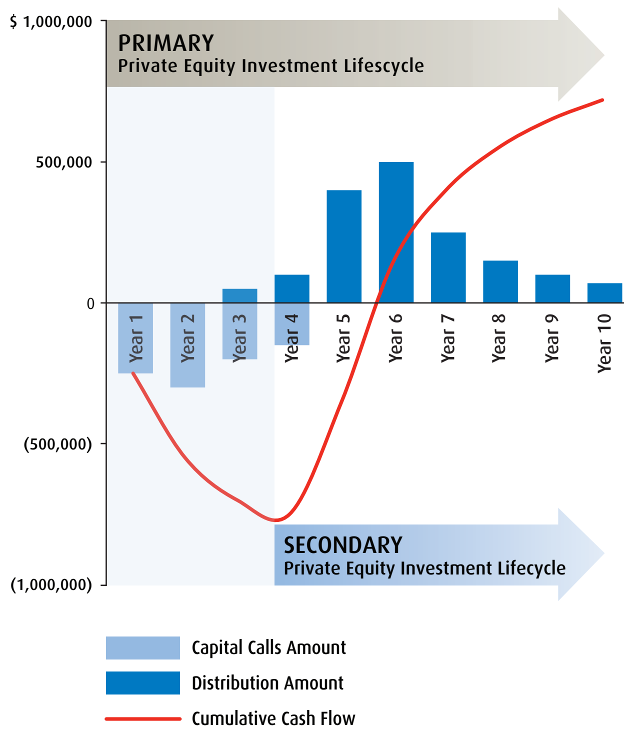
Evolution of the Secondary Market

Once a cottage industry with just a handful of participants, the secondary market has developed in recent decades into a full-fledged private equity strategy. Buoyed by robust growth in the primary market, the secondary industry has shed its stigma as a market of last resort for cash-strapped sellers and has evolved into an accepted conduit for active portfolio management. The result has been a strong upward trend in recent years in both transaction volume and secondary fundraising.



Source: Probitas Partners

FIGURE 2: MITIGATING THE J-CURVE



Source: CTC Consulting. Hypothetical private equity fund lifecycle

J-Curve Mitigation

By purchasing existing private equity assets, secondary funds exhibit reduced illiquidity duration relative to their primary fund counterparts. Due to the multi-year portfolio construction process of a primary fund, the early phase of the fund lifecycle is often marked by negative cumulative cash flow. During this period, an investor's cash outflow for new investments, management fees, expenses and effect of early write-downs exceeds cash inflow or valuation gain from the immature companies in the fund. This drives the negative performance often seen in the early years of a private equity fund. Ideally, as the fund matures, value is created; cumulative positive cash flows produced by investment exits overtake the investor's cash outlay. The result is a cash flow pattern that takes on a trough-like pattern known as the "J-curve."

Secondary funds are able to fast-forward through the uncertainty of early portfolio construction, acquiring seasoned funds near or beyond the end of their construction phase. Often, these funds are well into their liquidation phase and the timeline to distributions can be drastically truncated.

Diversification

Secondary funds provide investors a level of diversification not otherwise rapidly attained through primary fund investment. High investment minimums make diversified portfolio construction a difficult proposition for many investors. As a portfolio of numerous underlying fund interests, the exposure of a single secondary fund commitment will typically span a range of vintage years, geographies, investment strategies and industries. This broad level of diversification helps smooth the return volatility associated with primary investing.

For newcomers to private equity, the backward-looking vintage year and strategic diversification can be beneficial as they help to simulate a long-term, programmatic private equity portfolio via a single commitment. While ultimate diversification needs will vary by investor, secondary funds can be an effective way to accelerate the process.

FIGURE 3: SECONDARY FUNDS VS. ALL PRIVATE EQUITY – MEDIAN NET IRR

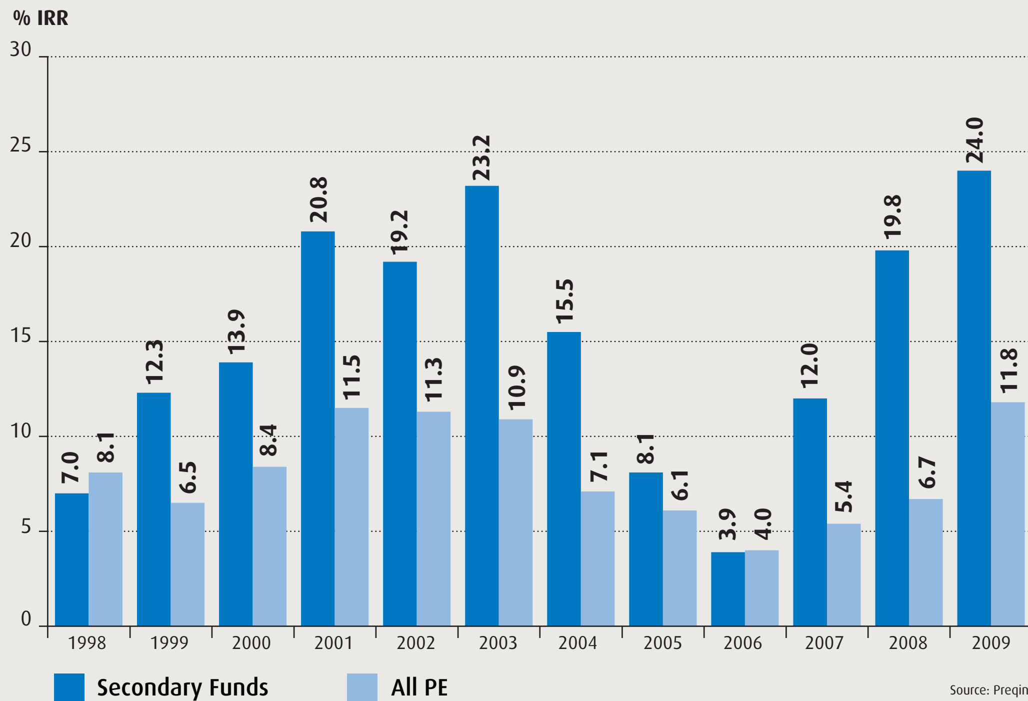
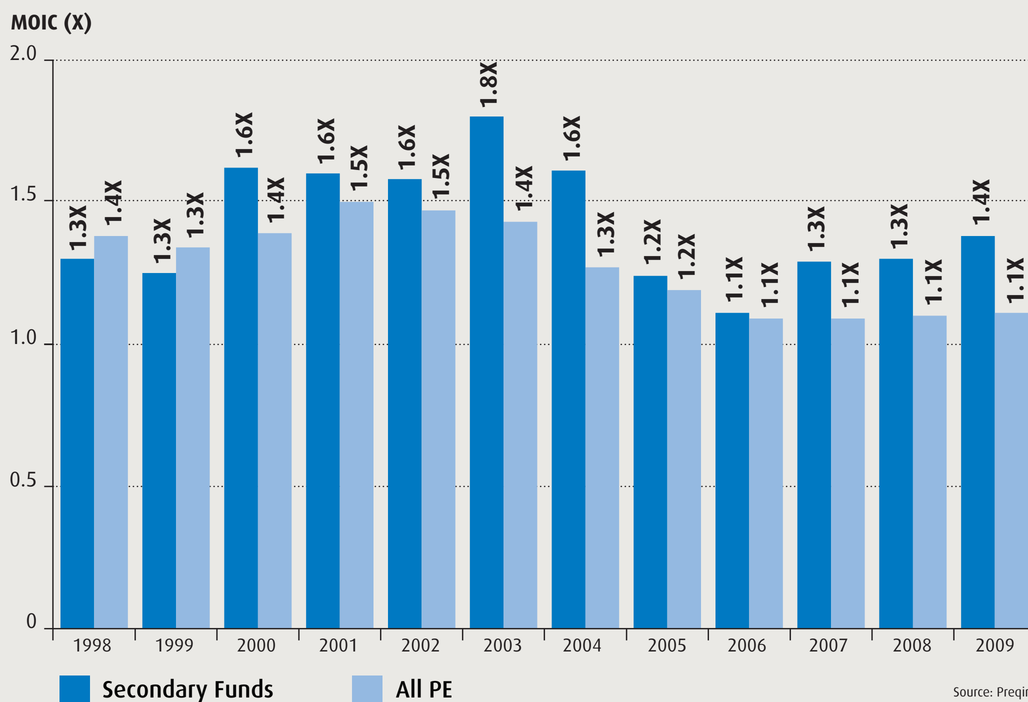


FIGURE 4: PERFORMANCE – SECONDARY FUNDS VS. ALL PRIVATE EQUITY – MEDIAN MOIC



SECONDARY FUND PERFORMANCE

As discussed on the previous pages, secondary funds provide exposure to private equity while limiting many of its inherent challenges. While these mechanical benefits are noteworthy, performance is what ultimately drives investor interest. A look at the historical returns of secondary funds reveals their success in providing compelling relative performance.

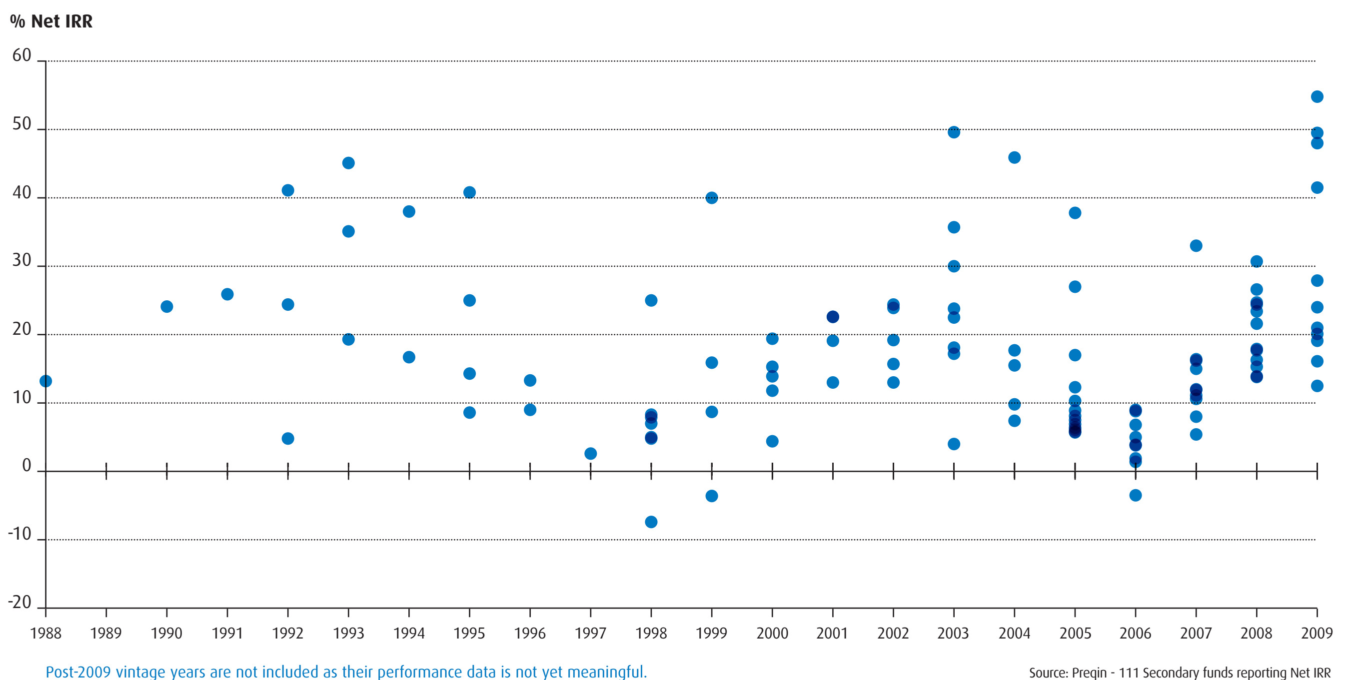
Historical Returns

From a performance standpoint, secondary funds have fared well in the context of the broader private equity landscape. According to data from private equity database Preqin, since 1998 secondary funds have outperformed the median net IRR of the broader private equity market in all but two years (Figure 3). Further, in the years of relative underperformance, it came at a very narrow margin.

The same holds true when looking at performance from a multiple of invested capital (MOIC) perspective, where, with the exception of two vintage years, secondary funds have outperformed all private equity (Figure 4).

Because secondary funds have the luxury of underwriting a set of existing assets well into their lifecycle, a degree of uncertainty is removed from the investment equation. While the upside return potential may be limited relative to top-quartile performance in buyout or venture capital strategies, the downside risk of secondary funds is also muted, as evidenced in Figure 5 below.

FIGURE 5: SECONDARY FUND VINTAGE YEAR PERFORMANCE LANDSCAPE – NET IRR



Post-2009 vintage years are not included as their performance data is not yet meaningful.

Source: Preqin - 111 Secondary funds reporting Net IRR

Examining the historical returns of secondary funds, one finds consistency in the asset class's ability to produce positive returns. Of the 111 secondary funds reporting a net IRR in Preqin's database, just three have produced a negative total return since 1988.

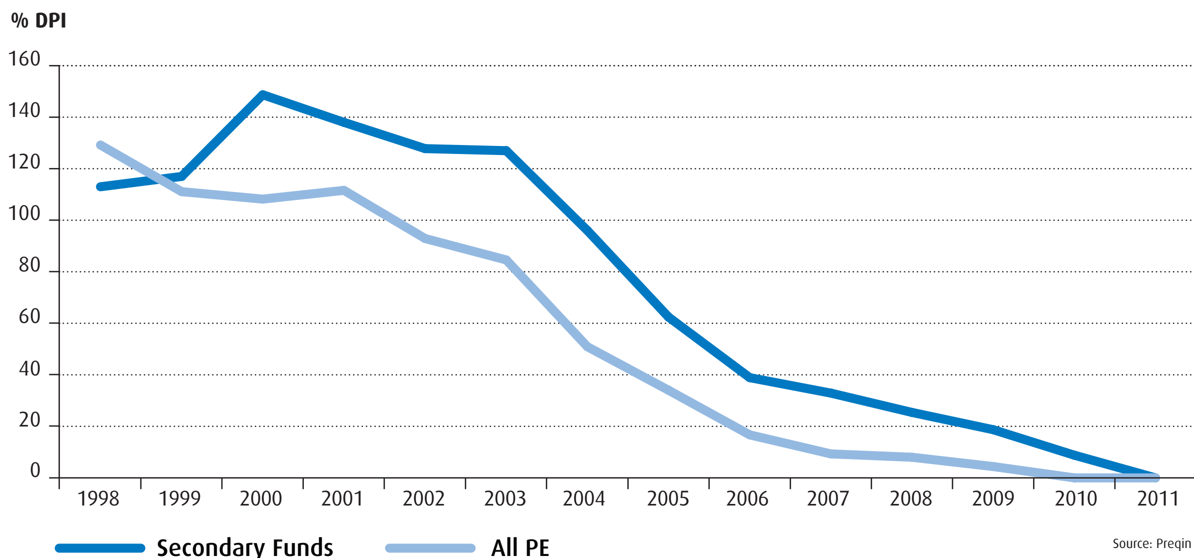
This accelerated pace of distribution helps new investors to private equity bridge the liquidity gap of their new commitments and serves as a funding source for other capital calls.

Accelerated Distributions

A key driver of the consistency in secondary outperformance is the previously discussed acceleration of distributions. Historically, secondary funds have been able to achieve relative outperformance while demonstrating a consistently elevated distribution pattern. A comparison of the distribution ratios of secondary funds from vintage years 1998 thru 2011 is outlined below in Figure 6.

This accelerated pace of distribution helps new investors to private equity bridge the liquidity gap of their new commitments and serves as a funding source for other capital calls. Similarly, for more mature portfolios, this distribution pattern can be beneficial in reaching and maintaining a "self-funding" portfolio, often a primary objective of long-term private equity investors.

FIGURE 6: DISTRIBUTIONS TO PAID IN CAPITAL - SECONDARY FUNDS VS. ALL PRIVATE EQUITY



BUT, WHAT ABOUT THE FEES?

All asset classes come with a unique set of risks and concerns of which investors must be aware. For secondary strategies, concerns are often associated with market dynamics (e.g. increasing competition, supply/demand balance, transaction activity, pricing). But perhaps the most common area of investor pushback regarding secondary funds centers on the issue of management fees. In a typical structure, an investor in a secondary fund pays a fee to the secondary fund manager who, in turn, must pay a fee to the managers of the acquired underlying fund interests.

> Secondary buyers are often entering into the picture paying a reduced management fee relative to the rest of the limited partnership.

Many potential investors find themselves asking, "aren't secondary fund limited partners saddled with paying multiple fee layers?" While multiple fee layers are indeed involved, for a couple of reasons the burden does not fall squarely on the investor in a secondary fund.

First, secondary fund interests tend to be acquired following the underlying fund's investment period – the point at which most fund management fees begin a reduction of some variety. Thus, secondary buyers are often entering into the picture paying a reduced overall management fee relative to the rest of the limited partnership.

Second, when secondary funds underwrite a potential acquisition, most do so on a "net-net" basis. The all-in cost, including management fees of the underlying funds, must meet the secondary fund's targeted return objective and be priced accordingly into the purchase amount. Thus, future management fees are effectively subsidized by the seller.

This structuring of fees helps explain why, despite the appearance of an adverse fee arrangement, secondary funds have historically been able to post compelling returns on a net-of-fee basis.

CONCLUSION

Secondary funds demonstrate a unique set of private equity portfolio management benefits while providing a stability of return relative to the broader private equity market.

The diversification, cash flow and return characteristics combine to create what CTC Consulting views as an accretive addition to the portfolios of new and experienced private equity investors alike.

RYAN COTTON

Senior Private Markets Research Analyst

Ryan Cotton specializes in private markets research and fund evaluation and helps guide clients with decisions related to illiquid investment strategies. Ryan earned a bachelor's degree from the University of Oregon and received his Master of Business Administration from the Johnson Graduate School of Management at Cornell University.

Prior to joining CTC Consulting in 2004, Ryan was with US Bank where he led a team responsible for credit analysis and administration of a diversified portfolio of lending products. He is a member of the Portland Alternative Investment Association and formerly served on the Board of the organization.

Tel: 503.228.4300 • ryan.cotton@ctcconsulting.com
CTC Consulting • 4380 SW Macadam Ave., Suite 490, Portland, OR 97239

Integrated Wealth Management

Independent investment advisory services and the comprehensive capabilities of a multi-family office.

- INVESTMENT CONSULTING
- ESTATE AND TRUST ADVISORY
- TAX PLANNING
- PHILANTHROPIC PLANNING
- FAMILY EDUCATION
- CAPITAL ADVISORY SERVICES
- RISK MANAGEMENT AND INSURANCE ADVISORY
- FINANCIAL REPORTING AND EXPENSE MANAGEMENT

United States Department of Treasury Regulation Circular 230 requires that we notify you that this information cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This information is being used to support the promotion or marketing of the planning strategies discussed herein. Harris myCFO, LLC and BMO Harris Bank N.A. and its affiliates do not provide legal advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

Harris myCFO® is a brand delivering services through Harris myCFO LLC, an investment advisor registered with the Securities and Exchange Commission and certain divisions of BMO Harris Bank, N. A. a national bank with trust powers. CTC Consulting is a brand used by Harris myCFO, LLC to deliver investment advisory and consulting services. Harris myCFO, LLC is an investment advisor registered with the Securities and Exchange Commission. Not all products and services are available in every state and/or location.

International investing, especially in emerging markets, involves special risks, such as currency exchange and share price fluctuations, as well as political and economic risks.

There are risks involved with investing in small cap companies including price fluctuations and lower liquidity.

The information and opinions expressed herein are obtained from sources believed to be reliable and up to date, however their accuracy cannot be guaranteed. Opinions expressed reflect judgment, and completeness cannot be guaranteed. Opinions expressed reflect judgment current as of the date of this publication and are subject to change. This presentation is not intended to constitute investment advice.

©2012 Harris myCFO®

Broader scope. Deeper insights.

CTC Consulting | Harris myCFO

CTC Consulting | Harris myCFO

This presentation is for informational purposes only and is not sufficient to form any basis or financial planning decision. **Please consult with your advisor in regard to your own personal situation.**

Please contact us for more information and/or for additional white paper titles or copies.

We look forward to the privilege of serving you. For more information, visit us at harrismyCFO.com or call 1-877-692-3611.