

Why Private Equity Secondaries Make Sense for Public Pension Funds

Jennifer Mink
Senior Consultant | Senior Partner
Investment Performance Services, LLC



What is Private Equity?

Asset class in which money is invested in privately-held companies to fund growth or new technologies, make acquisitions, or restructure inefficient companies.

Types of Private Equity Investments

Venture Capital

Financing for early stage, emerging or start-up companies (often in technology and healthcare sectors)

Buyouts

Acquisition of all or part of a company from its current shareholders; primarily mature businesses

Distressed Debt

Investments in the debt of companies undergoing financial distress (i.e. bankruptcy) to restructure/revive the company

Special Situations

Investments in a variety of event-driven corporate activities –spinoffs, mergers, acquisitions

Public vs. Private Equity

	Public Equity	Private Equity
Information Availability	Public; easily-obtained	Limited access to information
Fees	Lower fees; management fee only	Higher fees; management + performance fee structure
Liquidity	Daily	Illiquid
Valuations	Daily	Quarterly
Transparency	Publicly-available pricing	Limited pricing transparency
Benchmarks	Widely available; securities selected from benchmark index	Few benchmarks; most are not publicly available and may not be relevant
Leverage	Limited/none	Utilizes financial leverage
Value Creation	Limited control over value creation	Ability to improve value / implement change
Investment Focus	Quarterly-earnings focus	Long-term value creation
Return Goals/Potential	Relative; outperform benchmark index over a market cycle	Absolute, given lack of appropriate benchmarks; seeks substantial outperformance over public equity
Volatility	Similar to benchmark	Higher than US public equity

Private Equity Characteristics

Capital Commitment

Investors commit an amount to be invested, which is “called” by the private equity managers and invested over time

Drawdown

A fully funded commitment can take several years

Distributions

Distributions (committed capital and gains) are made when investments are realized (sold; IPO); often later in the life cycle of the Fund

Private Equity Characteristics

Blind Pool of Assets

Investors commit to a private equity fund before knowing the underlying portfolio companies

Vintage Year

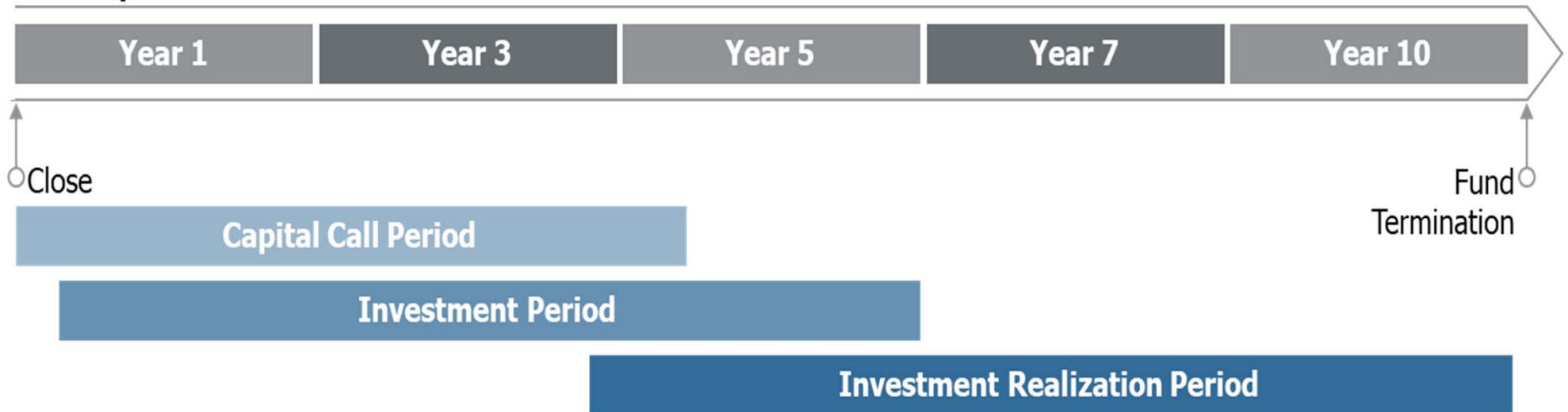
The first year in which a private equity fund calls capital and can be a key driver of performance

Illiquidity

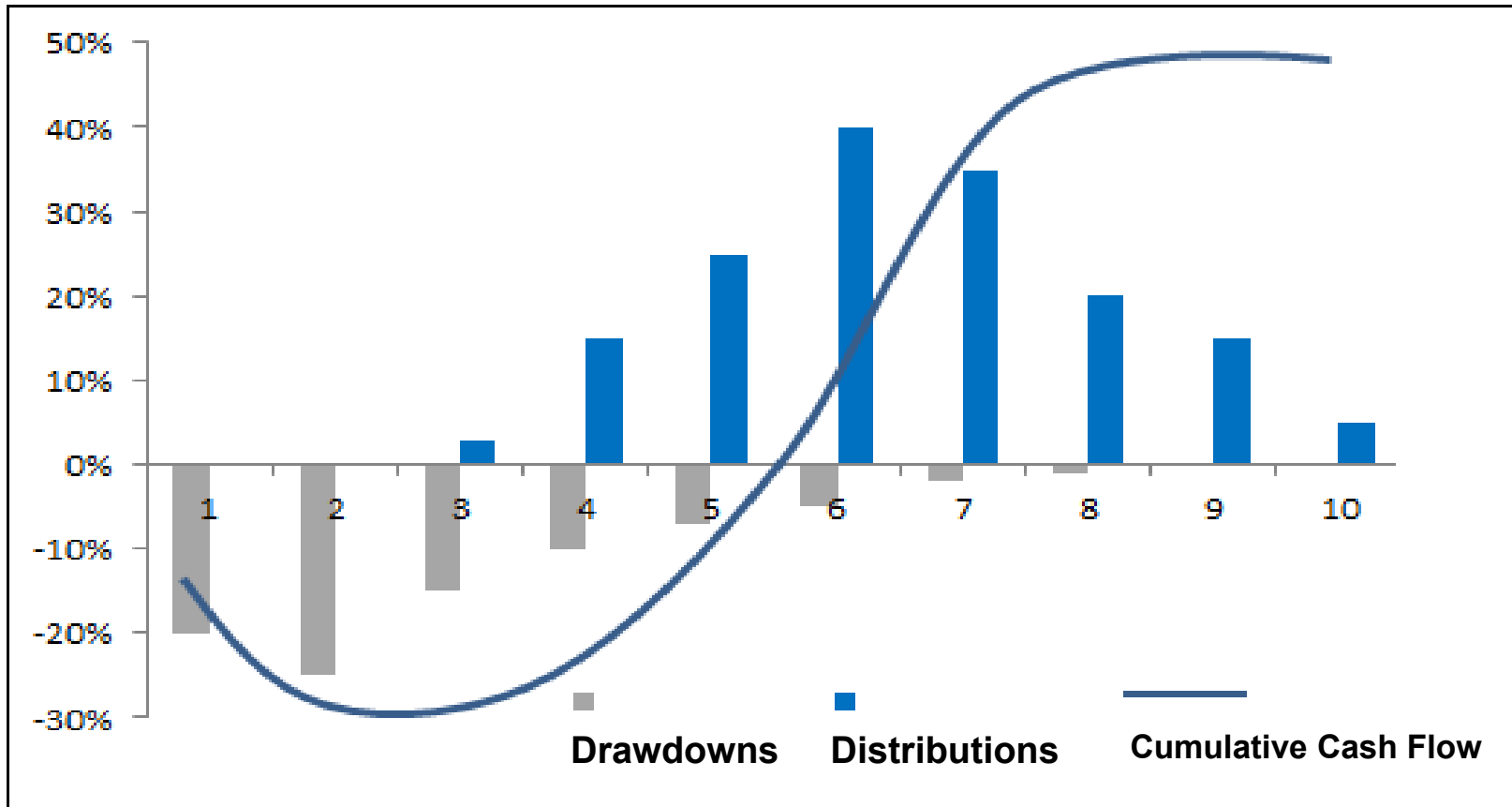
Once capital is committed, investors cannot access their money until distributions are made -Private equity lifecycles are often 10 years or more

Typical Timeline for Private Equity Investment

Subscription Period



J-Curve Effect



For illustrative purposes only. Not indicative of any particular investment.
Source: <http://blog.dealmarket.com/j-curve-analysis-could-impact-pe-industry/>



Potential Benefits of Private Equity

Large Opportunity Set

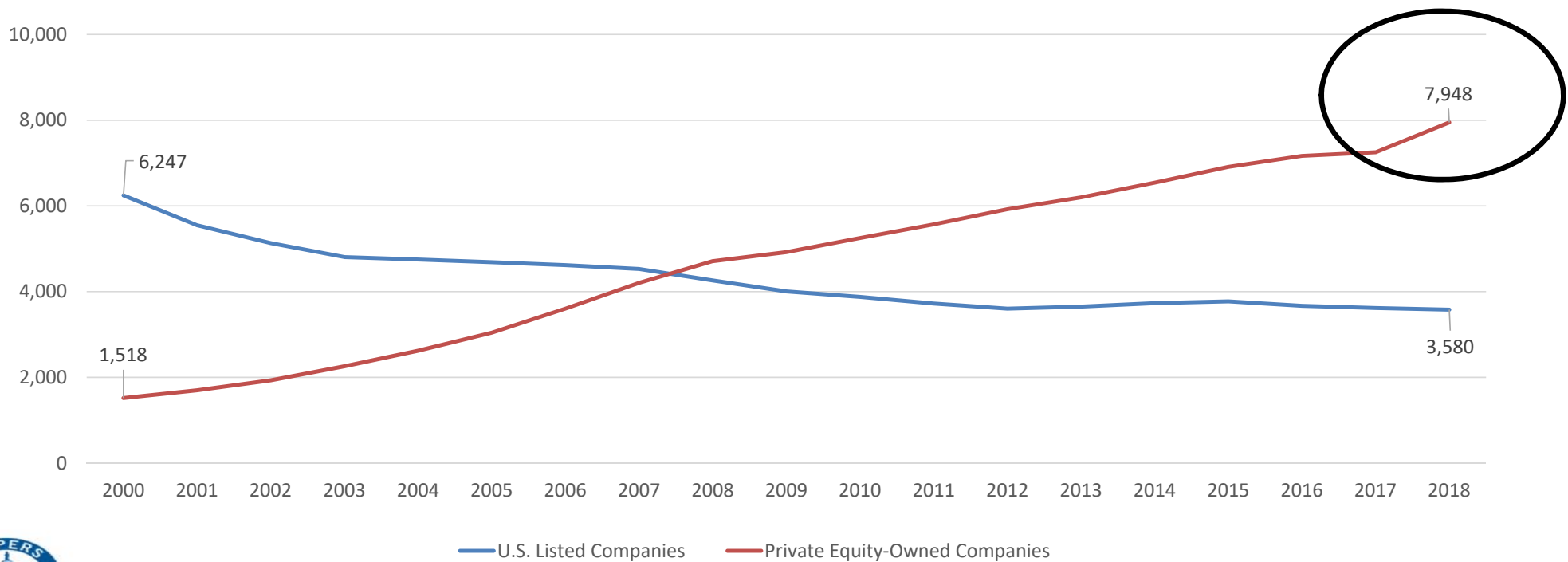
Attractive Returns

Low Correlation

Operational Value Add

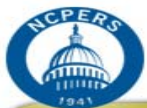
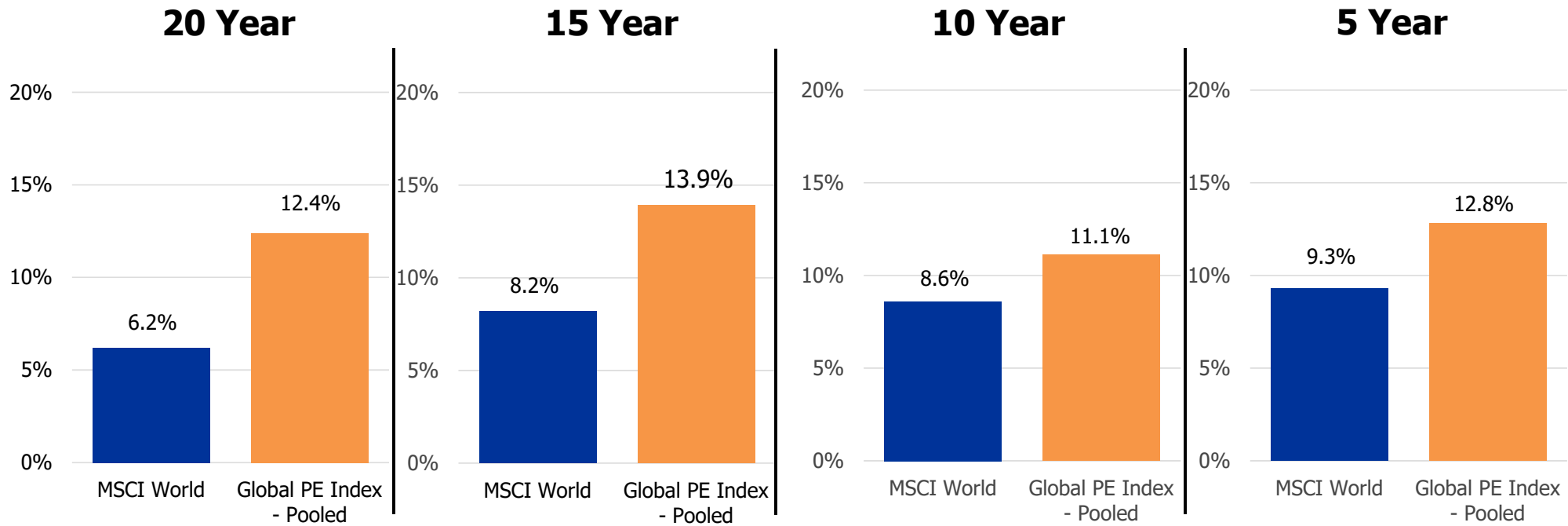
Large Opportunity Set

U.S. Listed Companies vs. Private Equity-owned Companies



Source: Public from University of Chicago Center for Research in Security Prices as of December 31, 2018. Private from PitchBook: "2018 Annual US PE Breakdown."

Attractive Historical Returns



Source: Represents the investment horizon for Global Private Equity Index from Thomson Reuters as of September 30, 2018, which is the latest data available. Past performance is not indicative of future results. Please refer to the Endnotes for definitions of indices. Provided courtesy of Neuberger Berman.

Industry Expectations for Asset Class Returns

Asset Class	2012	2018	Difference
	10+ years	10+ years	
US Large Cap Equity	9.4%	6.1%	-3.3%
US Small/Mid Cap Equity	10.5%	6.6%	-3.9%
International (Developed) Equity	9.9%	6.7%	-3.2%
Emerging Markets Equity	12.6%	7.6%	-5.0%
Investment Grade Fixed Income (Core)	4.1%	3.4%	-0.7%
High Yield Bonds	7.4%	4.8%	-2.6%
Non-US (Developed) Fixed Income	3.8%	2.2%	-1.6%
Non-US Emerging Markets Fixed Income	7.2%	5.0%	2.2%
Cash	2.8%	2.5%	-0.3%
Real Estate	7.6%	5.9%	-1.7%
Hedge Funds	7.3%	4.9%	-2.4%
Infrastructure	8.3%	6.6%	-1.7%
Private Equity	12.9%	8.3%	-4.6%

Future expected returns declined for all asset classes!



Operational Value Add

Public Equity

Buy	<ul style="list-style-type: none"> • Only have public info • Efficient market
Hold	<ul style="list-style-type: none"> • Limited to no ability to affect change
Sell	<ul style="list-style-type: none"> • No ability to “position” company at sale

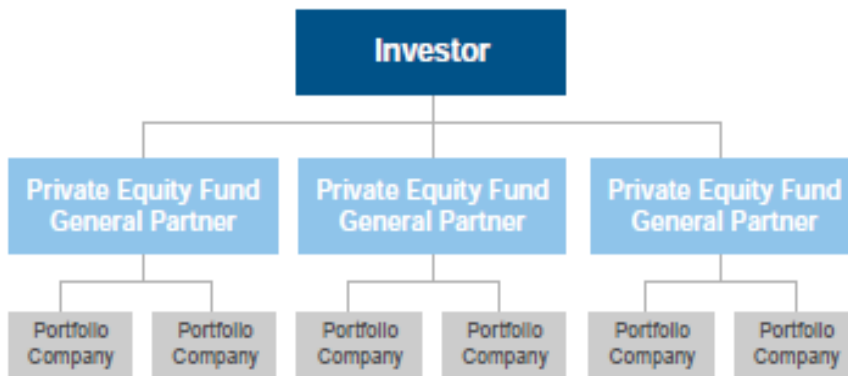
Private Equity

Buy	<ul style="list-style-type: none"> • Access to private information • Efficiencies result in valuation asymmetries
Hold	<ul style="list-style-type: none"> • Management alignment • Focus on operational improvements & enhance cash flows
Sell	<ul style="list-style-type: none"> • Multiple options for exit • Patient capital that can optimize exit timing



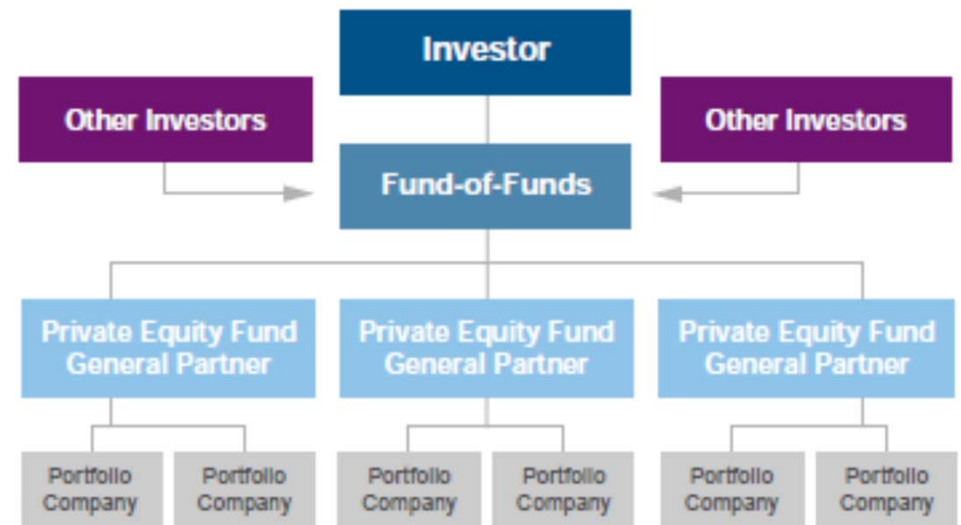
Implementation

Invest Directly in Private Equity Funds



- Need to allocate to multiple private equity funds per year over a multi-year period to build a diversified portfolio
- Operational challenges ; requires significant resources

Invest in a Private Equity Fund-of-Funds



- May offer broader diversification among managers and strategies –aims to deliver more consistent returns, less risk
- Fees are charged at two levels

Drawbacks of Private Equity

Internal Rate of Return

Because cash is invested at different points over time, returns are calculated using the internal rate of return (IRR) –a measure of performance based on cash flows to and from the investor.

Exit Strategy

Underlying portfolio companies are typically exited via an initial public offering (IPO) or sale to another buyer. Market stress or a variety of economic factors could inhibit an exit.

Drawbacks of Private Equity

Lack of Benchmarks

Private equity investments usually seek to outperform public equities over a long period of time, and while there may be a few publicly-available private equity benchmarks, they may not be truly representative of a particular private equity fund.

Fees

Much higher than public equity and generally include both an annual management fee and “carried interest”, an incentive fee representing the manager’s share of the profits earned. Fees are also usually paid on committed, rather than invested, capital.

Private Equity Allocation Options

Investment Type	Description
Primary Fund Investment (Direct Investments)	Limited Partnership structures formed to make investments in private companies. Investor capital is called over time as the General Partner identifies investment opportunities within the stated mandate.
Secondary Fund Investment	Limited Partnership structures formed to purchase interests in existing Private Equity partnerships, often at a discount to the current Net Asset Value. Some Secondary Funds also participate in General Partner restructuring transactions.
Co-Investment Fund Investment	Investment funds structured to invest alongside General Partners of Primary Funds in transaction where the General Partner needs additional capital to complete the transaction.
Fund-of-Funds	Investment funds structured to allocate to underlying primary funds. Can also include allocations to secondary investments and co-investments.



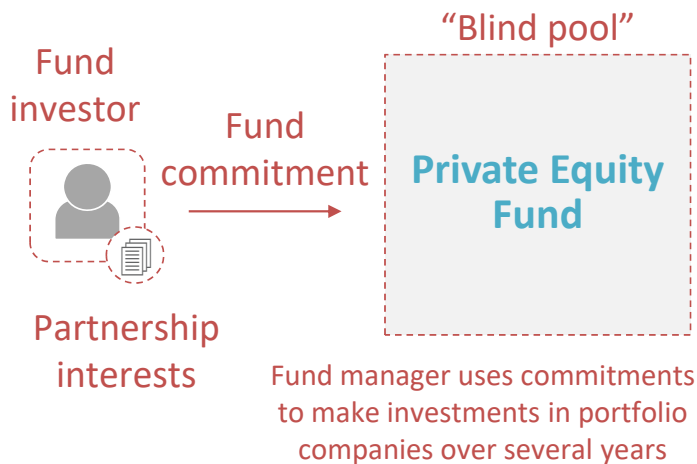
What is a Private Equity Secondary Investment?

Involves the purchase of an existing private equity fund interest from a limited partner (investor) that is seeking liquidity by selling their position to another investor

A secondary investment involves the purchase of existing partnership interests in a private fund.

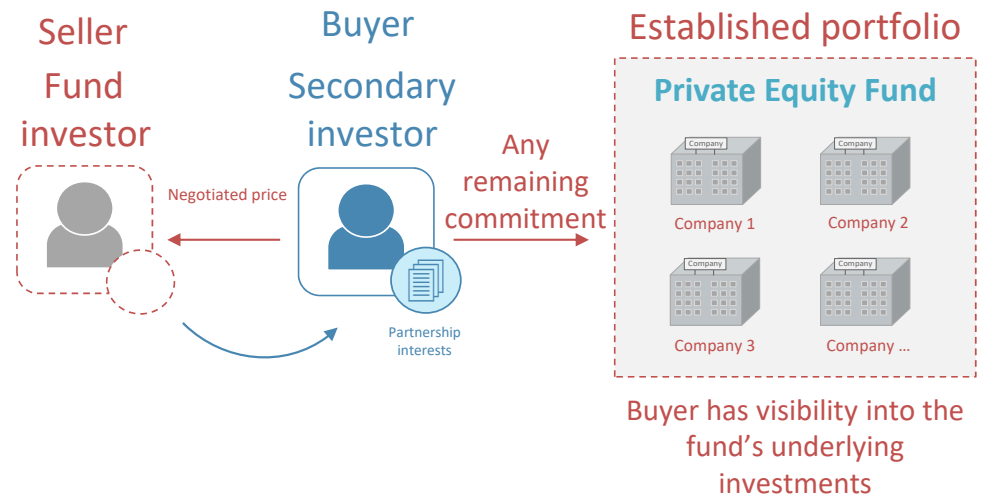
Primary Fund Investment

In a primary fund investment, a fund investor commits capital to a fund, typically before any investments have been identified by the manager (“blind pool commitment”).

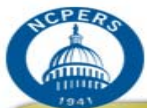
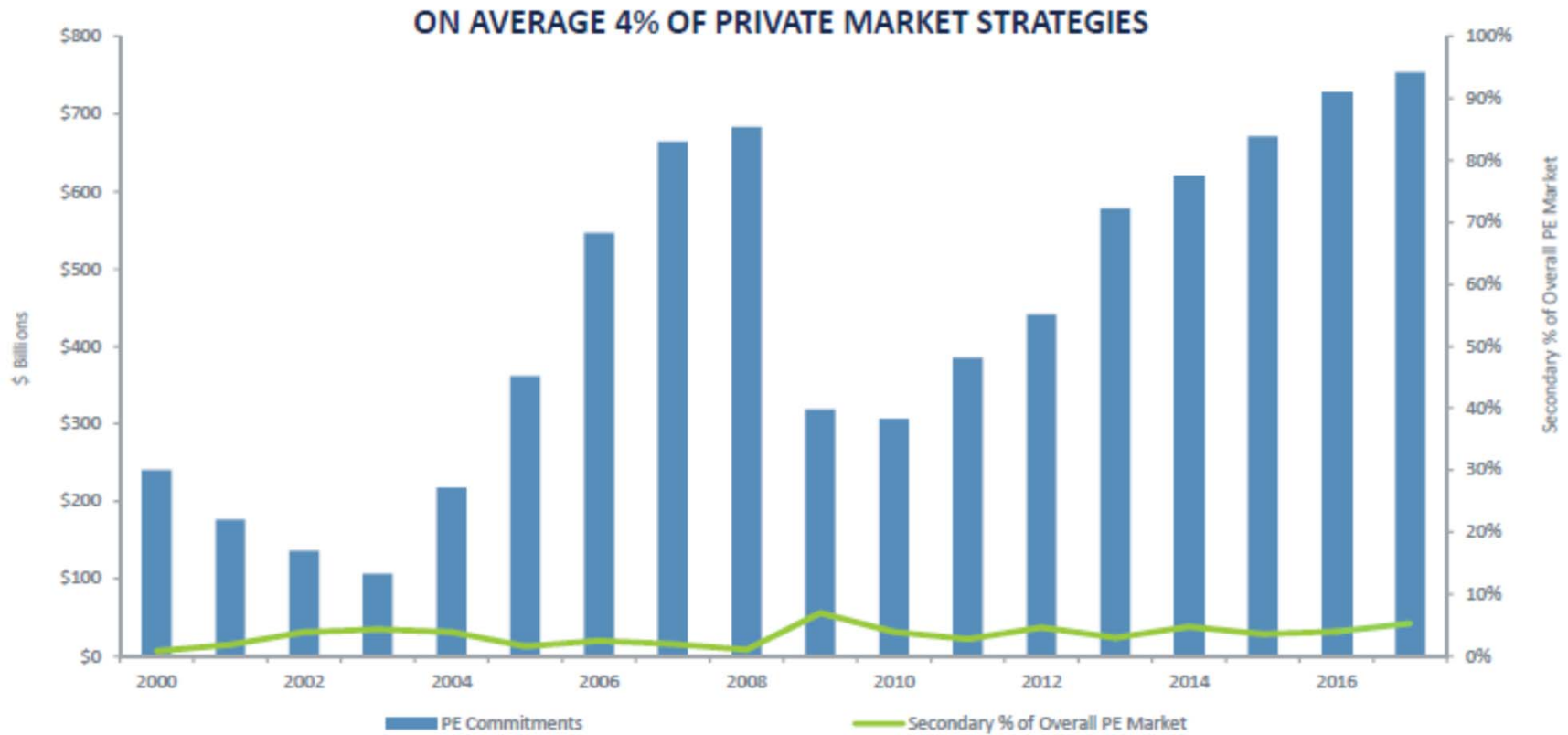


Secondary Investment

In a secondary investment, an investor purchases an interest in a fund in “mid-life” from an existing investor for a negotiated price. The buyer now has exposure to the existing portfolio of investments and is responsible for any remaining commitment to the fund.



Private Equity Secondary Market Transaction Volume



Source: Preqin as of December 31, 2017. via Glouston Capital Partners

Why do Private Equity Investors Sell their Holdings?

Secondary market provides liquidity to investors in private equity, allowing them to sell private equity investments prior to the contractual maturity of those investments



Need Liquidity

Rebalance Portfolio

Seek New GP Relationships

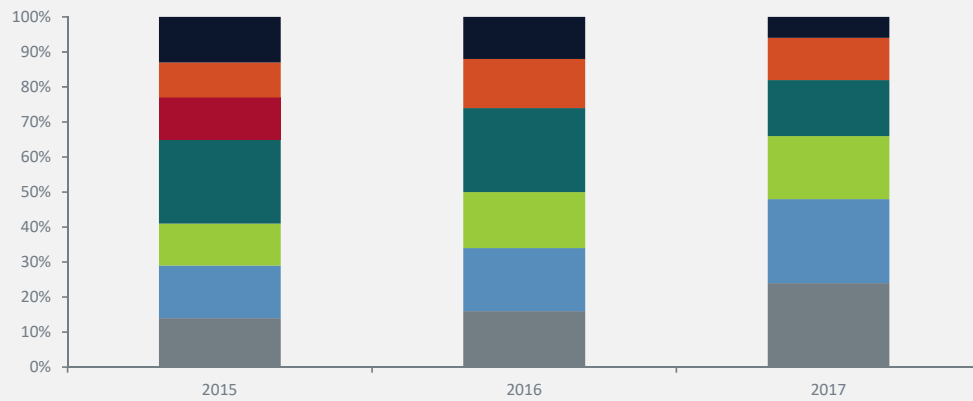
Realize Gains

Manage Administrative Burden

Highly coveted funds may trade above NAV

Who is Selling?

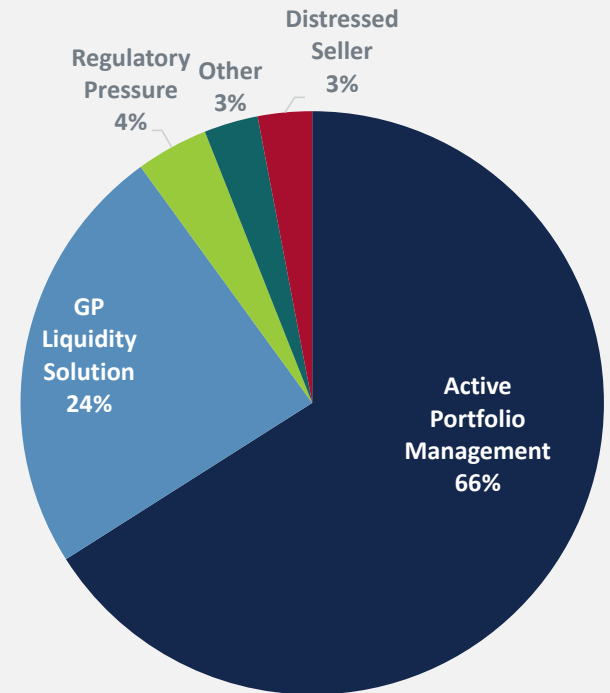
Secondary Activity by Sellers



- Public Pension / SWF
- General Partner
- Fund-of-Fund
- Endowment & Foundation
- Corporate Pension
- Financial Institution
- Other

Source: Greenhill & Co. as of December 31, 2017

BROAD SELLER MOTIVATIONS



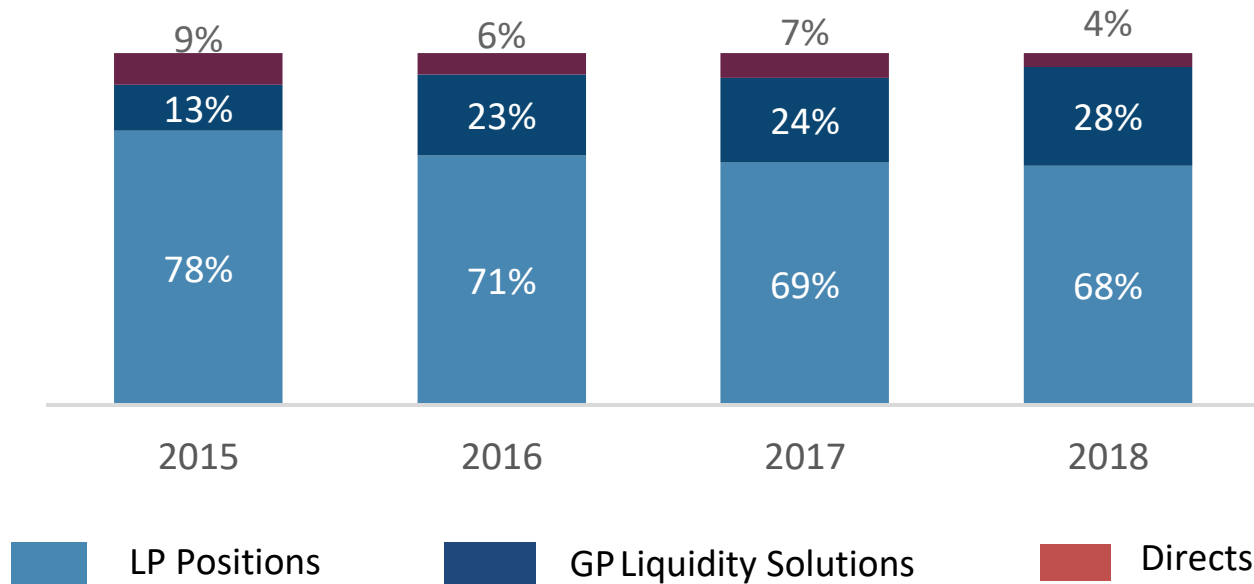
Source: Evercore Private Capital Advisory as of December 31, 2017



Evolving Secondary Market Landscape

% of GP led transactions continue to grow*

Transactions by Year



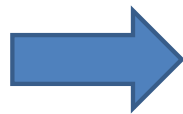
* Source: Evercore Private Capital Advisory, 2015 Secondary Market Survey Results, January 2016; 2016 Secondary Market Survey Results, January 2017; 2017 Secondary Market Survey Results, January 2018; 2018 Secondary Market Survey Results, January 2019. Courtesy of GCM Grosvenor.

GP Led Transactions

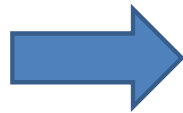
Typically involve private equity funds that are approaching, or have exceeded, the end of the fund's stated life but still have assets remaining in the fund.

They are often structured to provide liquidity to LPs while allowing the GPs additional time to maximize portfolio company values.

Examples:

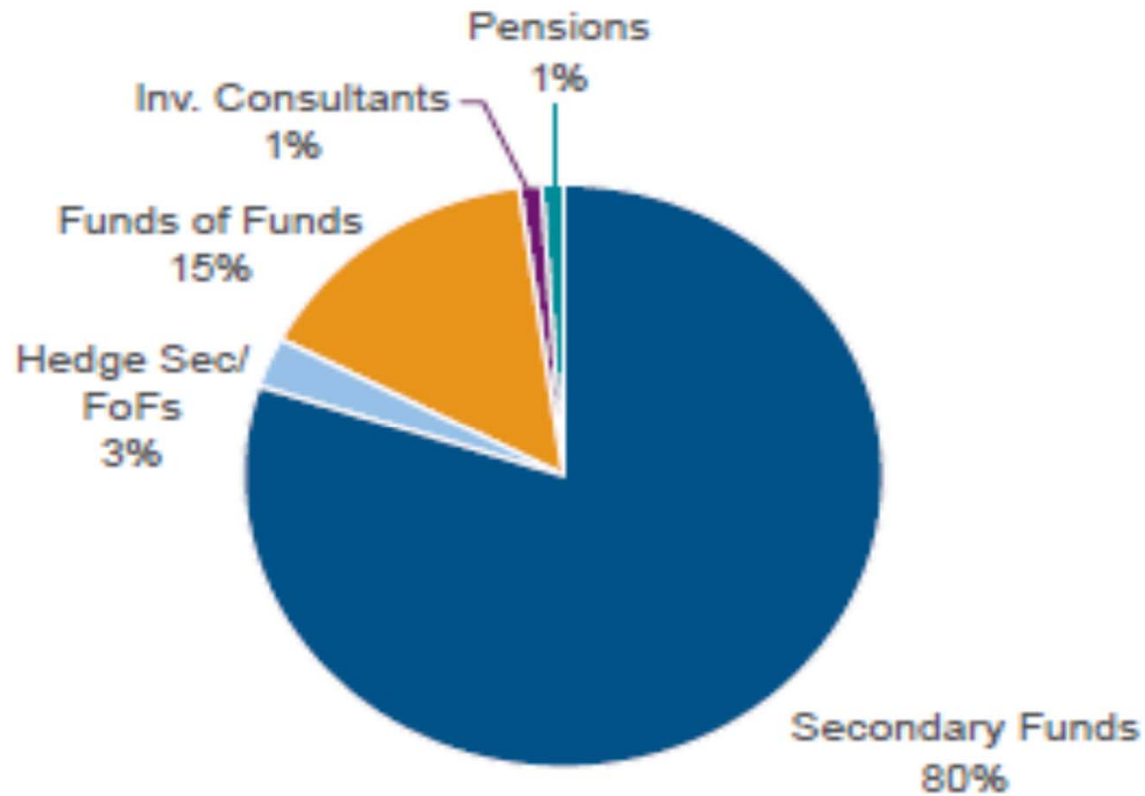


Tender offer for LP Interests: GP facilitates offers from one or more buyers for all or portion of fund's LP interests



Fund Recap: Sale of all or significant portion of the fund's assets into a new special purpose vehicle to be managed by the GP

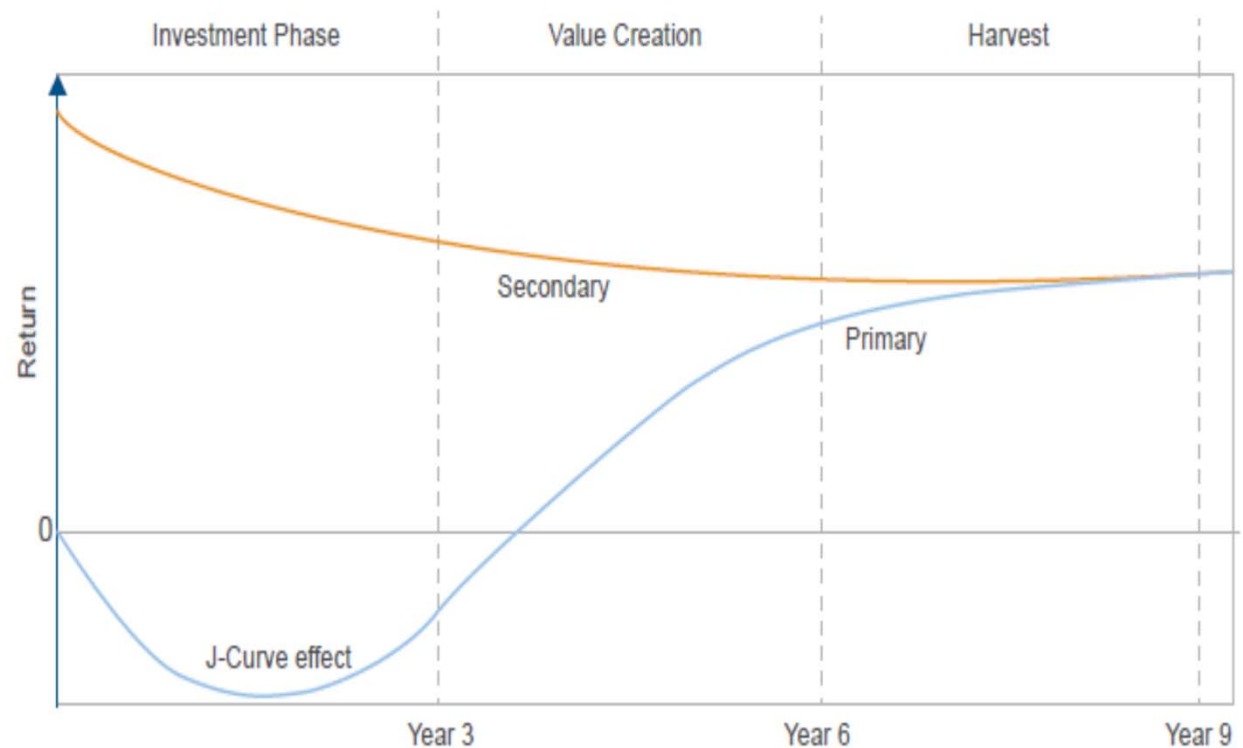
Who is Buying?



Why Do Investors Buy on the Secondary Market?

Mitigated "J"-curve

Due to the earlier distribution of capital back to investors from investing in more mature private equity funds, secondary investments are able to help mitigate the J-curve associated with primary fund investments.



Why Do Investors Buy on the Secondary Market?

Buying at a discount

Secondary fund interests are often purchased at a substantial discount to net asset value (NAV); although some can trade at NAV or even at a premium to NAV

Known pool of assets

Secondary market buyers are purchasing a fund in which the portfolio companies are known and the risks of those companies can be evaluated before purchasing the interest

Why Do Investors Buy on the Secondary Market?

Broader Diversification

Investments can be made based on vintage year, strategy type, asset class, industry, geographic region

Vintage Year IRRs

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Upper Quartile	13%	16%	19%	17%	20%	19%	17%	20%	18%	14%
Median	8%	10%	14%	10%	13%	13%	11%	14%	8%	-2%
Lower Quartile	4%	5%	9%	7%	8%	8%	7%	8%	-4%	-23%

Significant dispersion exists among vintage years and the top-performing and bottom-performing managers.



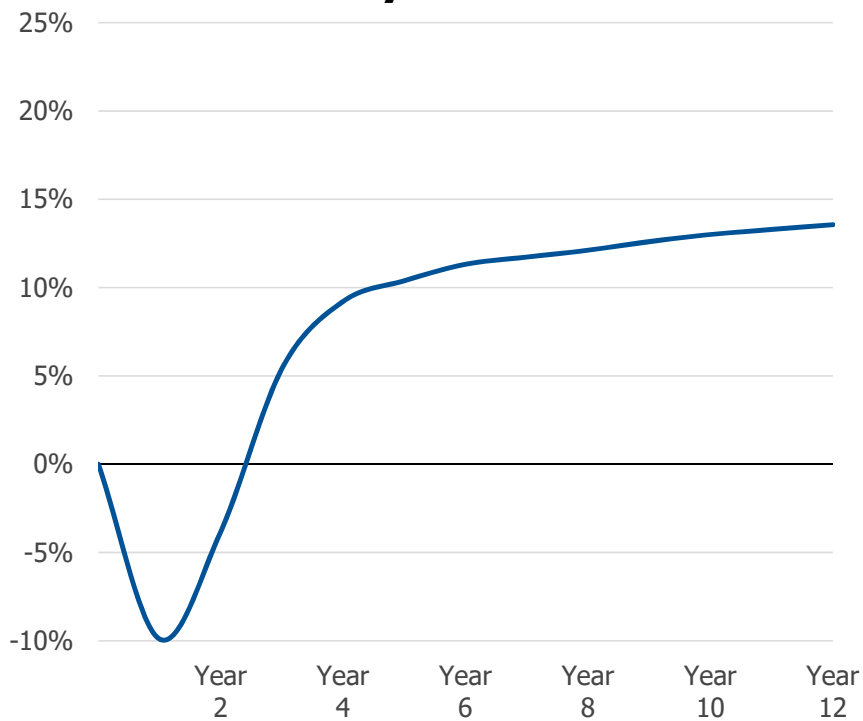
Why Do Investors Buy on the Secondary Market?

Predictability

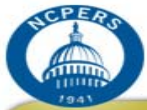
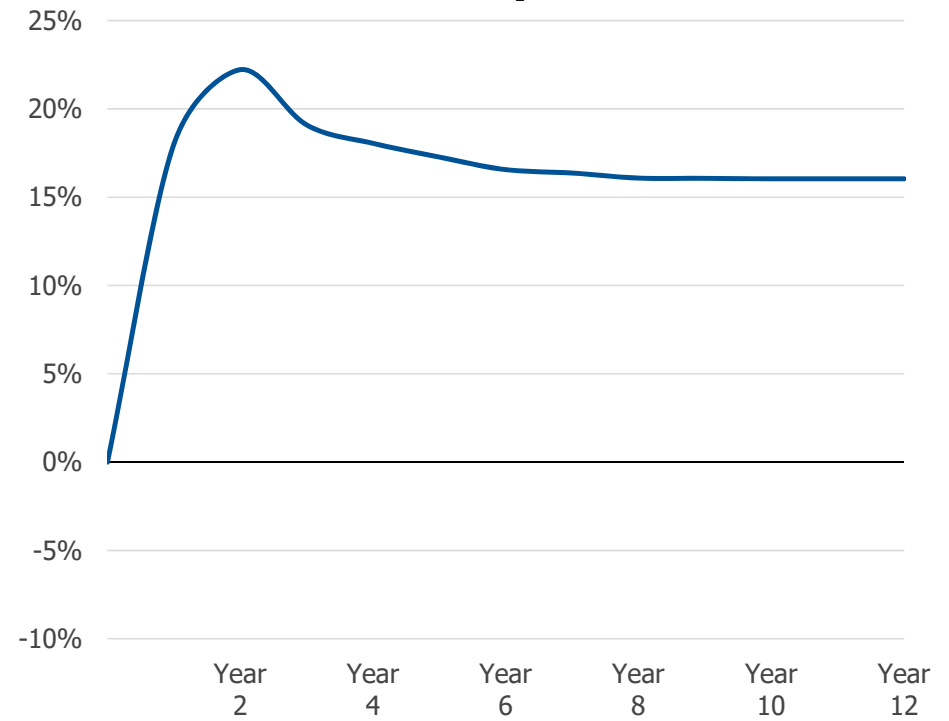
A potentially more predictable outcome than a primary fund investment, though the potential for significant outsized returns may be reduced along with the generally lower risk

Gross Internal Rate of Return

Primary Fund



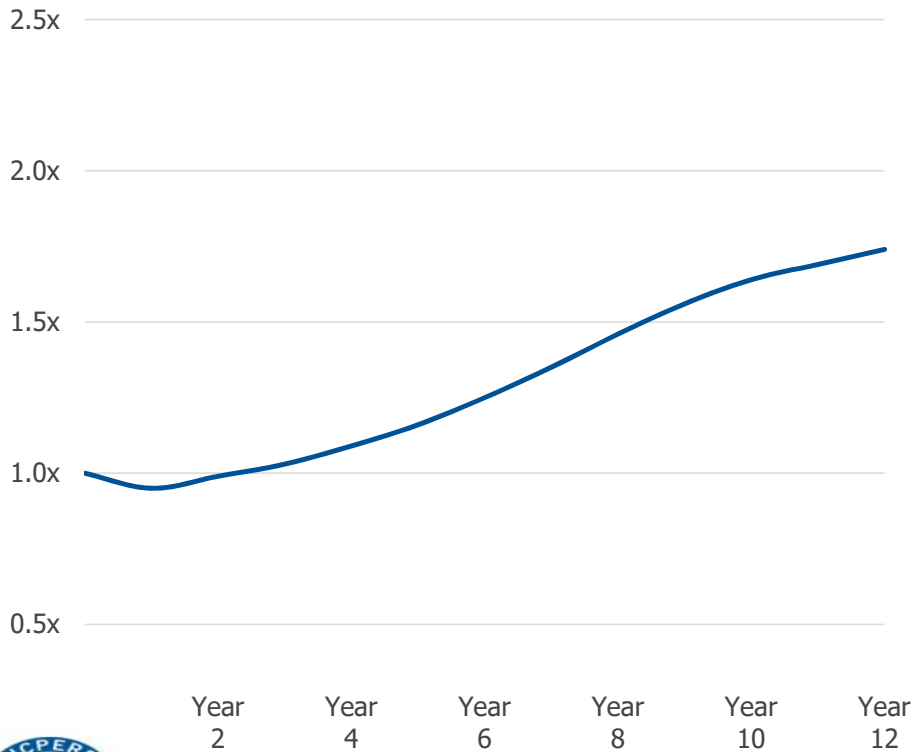
Secondary Fund



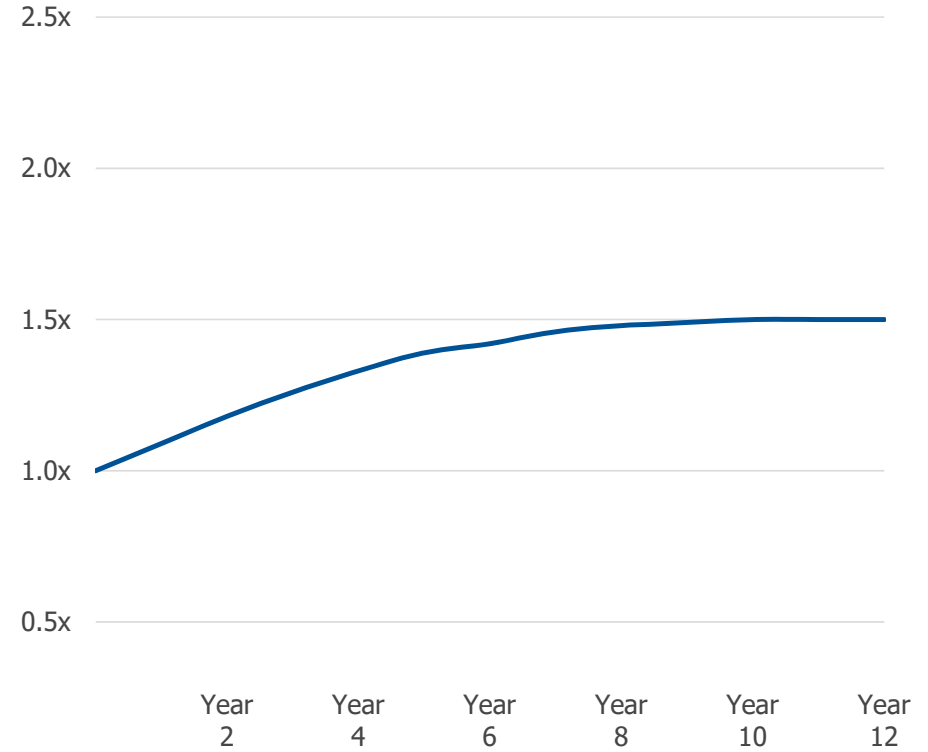
FN: Note: The J-curve illustrated above is for illustrative purposes only and does not represent the J-curve of any specific private equity fund. There is no guarantee that the return profile of primary investments will resemble the above graph or that they will deliver all, or any, of the above benefits. Actual performance may vary. Note, net returns will be lower. Courtesy of Neuberger Berman.

Distributed to Paid-In

Primary Fund



Secondary Fund



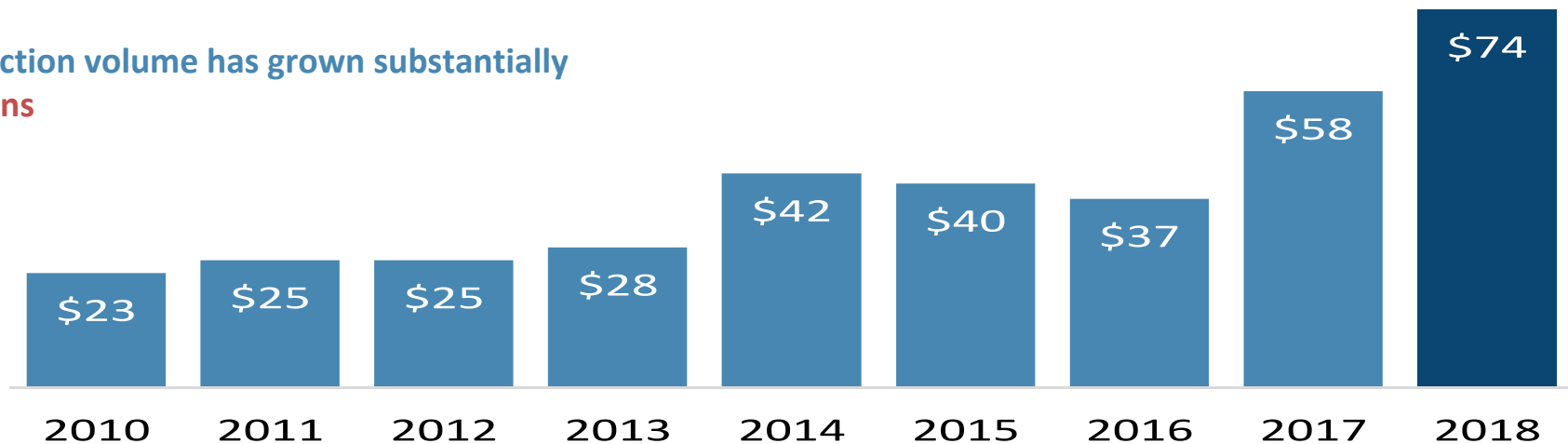
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Private Equity Secondary Considerations

Crowded
Market

Secondary market transaction volume has doubled in the last 5 years. Although deal supplies remain strong, finding attractive opportunities in a segment that could be increasingly crowded may present a challenge.

Transaction volume has grown substantially
\$ billions



Source: Greenhill Cogent, Secondary Market Trends & Outlook, January 2019. "All Strategies" includes buyout, venture, real estate, mezzanine/distressed, fund-of-funds and energy/infrastructure strategies. Courtesy of GCM Grosvenor.

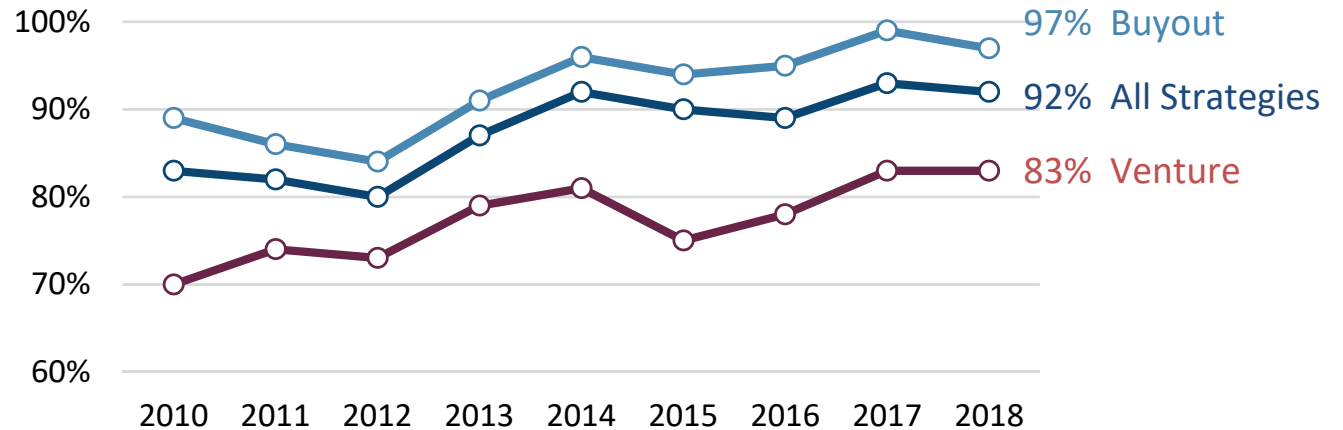
Private Equity Secondary Considerations

Increasing Pricing

Following a decline from a 9% premium to NAV in 2006 to an average discount of 37% in 2009; competition for deals has driven the average discount to 5% in 2017.

Pricing has tightened, but still a “discount” market¹

Average secondary pricing, % of NAV



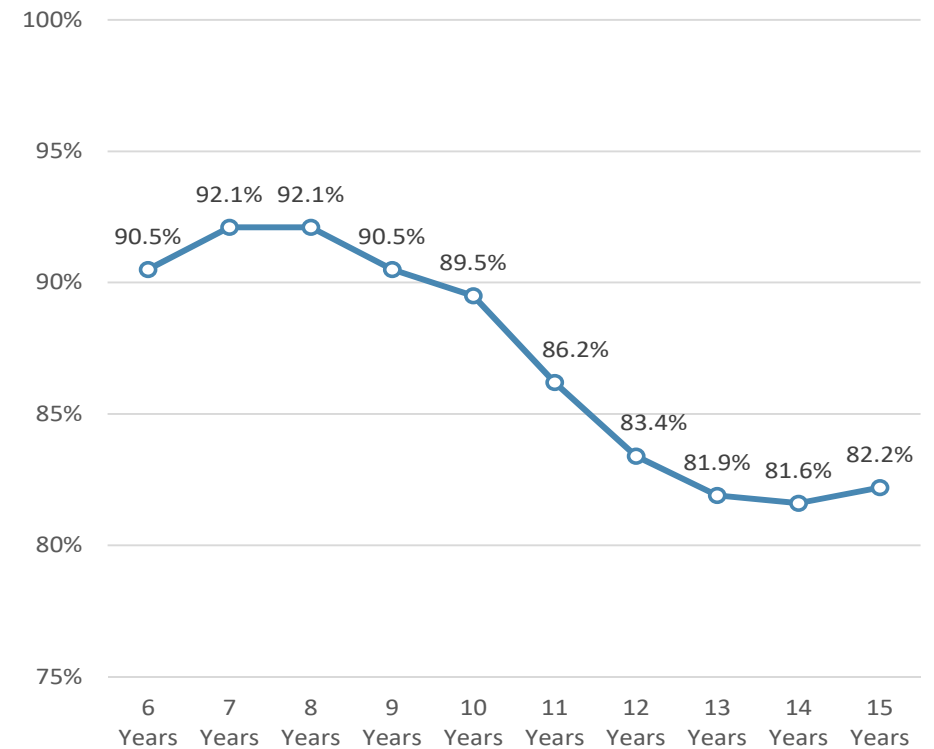
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Pricing Factors

- **Fund age** →
- **Underlying companies**
 - Quality
 - Volatility
 - Upside potential (carrying values)
 - Overall cash flow duration
- **Manager**
 - Quality/franchise risks
 - Familiarity
- **Activity subsequent to reference date**
 - Valuation adjustments (IPOs, Exits, Public market movements)
 - Cash activity
 - Pro-forma discount/premium
- **Visibility**
 - Carrying values/exit assumptions

Secondary Market Pricing by Age¹

As a % of NAV, 2010 to August 2015



¹ Greenhill Cogent complete transactions since 2010. Excludes pricing points received more than six months after the transaction record date.
 Source: Greenhill Cogent - Secondary Sale Rationale, August 2015. Courtesy of GCM Grosvenor

Private Equity Secondary Considerations

Older
Vintages

Secondary investments only provide exposure to previous vintage years not future vintages

Public Markets
Influence

Volatility in public equities has the potential to increase the number of distressed sellers of partnerships, which may be good for pricing...but also has the potential to reduce valuations of underlying portfolio companies

Private Equity Secondary Considerations

Leverage

Some secondary funds utilize leverage to potentially enhance returns....however, this can increase the risk of the fund if investments do not perform as expected

Key Takeaways

- Utilize managers whose primary business is private equity
 - Deep research teams
 - Access to a breadth of deals
 - Strong track records across vintage years
- Reduce risk by diversifying across funds, strategies, and vintage years
- Diversify portfolio allocation by utilizing primary and secondary investments; Fund of funds
- Cash flow needs should be analyzed before considering a commitment to private equity

Questions?

Thank you!

Jennifer Mink
Senior Consultant | Senior Partner
Investment Performance Services, LLC
jmink@ips-net.com



Index Disclosure

Cambridge Associates Global Private Equity Index: Based on data compiled from 2,450 private equity funds, including fully liquidated partnerships, formed between 1993 and 2016. Internal rates of returns are net of fees, expenses and carried interest. CA research shows that most funds take at least six years to settle into their final quartile ranking, and previous to this settling they typically rank in 2-3 other quartiles; therefore fund or benchmark performance metrics from more recent vintage years may be less meaningful. Benchmarks with “—” have an insufficient number of funds in the vintage year sample to produce a meaningful return.