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Perspective from Lexington Partners

Unlocking opportunities: Understanding the growing secondary market

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Global secondary transaction volume has grown rapidly in recent years. Lexington estimates secondary industry volume reached a record high of $128 billion in 2021 and exceeded $100 billion in 2022 and 2023. Several factors are driving this growth, including primary fundraising volume, limited partners (LPs) seeking liquidity in the absence of distributions, and general partner (GP)-led transactions. In 2024, the secondary market remains undercapitalized versus a significant supply of deal flow, setting the stage for a robust buyer's market.

We begin with a high-level primer on the market, how it works, and its potential benefits as an investment strategy. Later, we will explore the opportunities in the secondary market in more depth.

A secondary market primer

What is a secondary transaction? Essentially, it is what its name implies. It is a secondary transaction in the private equity (PE) market where an existing exposure in a private investment fund is either bought or sold. PE funds have long term lockups, typically between 10 and 13 years, so investor capital is illiquid. The secondary market offers a liquidity option for investors who may need cash, are looking to change their portfolio allocation, or re-balance their holdings to return to a target allocation. To do so, they work with firms that specialize in secondary market deals, which serve as liquidity providers to investors in private assets. This is particularly appealing to institutional investors and other LPs looking to manage their portfolios more actively.

There are two primary types of secondary market transactions. The first is the traditional LP transaction, where an original limited partner in a private equity fund may sell one or more partnership interests. The LP works with a secondaries firm to negotiate a purchase and sale agreement to buy that exposure. The transaction could be for a single partnership interest, or it could be a large portfolio of underlying interests. There are many different types of deal structures, but the underlying exposures do not change. Beyond having to approve the transfer, the GP is essentially a passive party, and the secondaries firm steps into the selling LP's shoes as the new transferee. The economics of the underlying fund do not change.

The second most common transactions are GP-led deals. The GP-led secondary market has been getting a lot of press in recent years, as it has been increasingly popular with both sponsors and buyers. As with LP transactions, there are many different types of GP-led deal structures. The most common transactions include continuation funds and tender offers. In these instances, it is the GP initiating the secondary transaction, working with a set of buyers to craft a deal to provide liquidity options to a group of LPs in an organized way. In these transactions the GP plays an active role, either running a tender offer for a fund, or creating a continuation vehicle (CV).

A CV enables the sale of a single company or a portfolio of companies from an older private equity fund into a newly established vehicle. In this way, liquidity can be offered to the original investors, while the GP continues to own and add value to the business. Original investors typically have the option of taking the liquidity at the negotiated price, or they may elect to reinvest into the new CV. GPs often pursue CVs so they can hold high-quality assets for longer than the planned life cycle, with the intent of continuing to compound capital.

Why invest in secondaries?

The attractiveness of the secondary market in private equity can be attributed to several factors, and the appeal may vary depending on the perspectives of different market participants. Here are some reasons we consider secondaries attractive:

Mitigation of primary J-curve

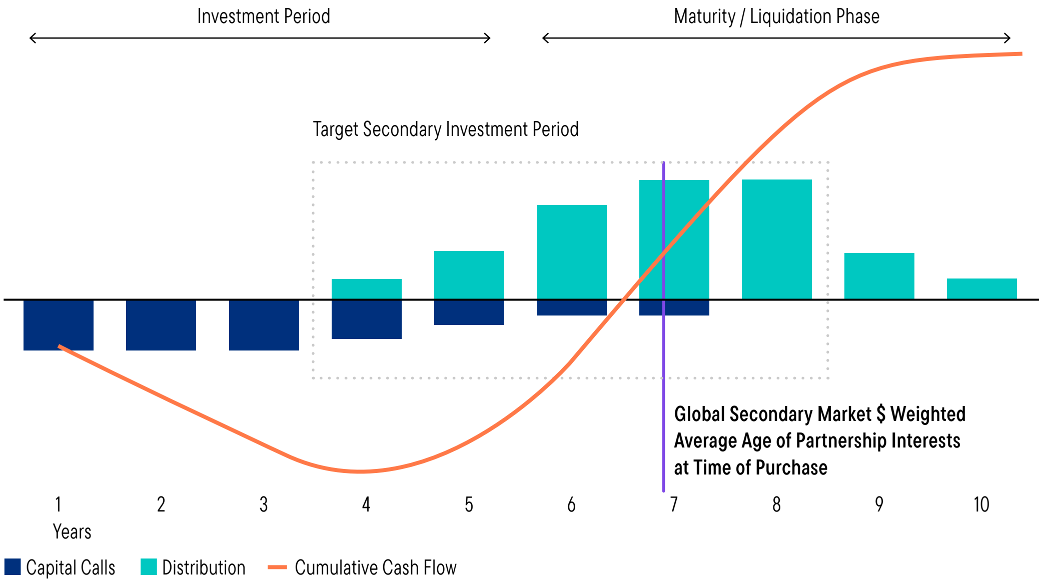
The J-curve refers to the graphical representation of the typical pattern of cash flows that a private equity fund might experience over its life cycle. Private equity involves investing in privately-held companies, often with the goal of improving their performance and later selling them for a profit.

The J-curve graph (Exhibit 1 on the next page) typically shows a negative cash flow during the initial years of the fund's life, followed by a positive cash flow in later years. The horizontal axis represents time, while the vertical axis represents the fund's cash flow.

In Exhibit 1, we can see the cash flow profile of a traditional private equity fund. The blue bars are the capital calls in the beginning stages of the investment, drawn from the LPs in the private investment fund. This generally happens in years one through five, as the GP deploys capital into portfolio company investments. As those investments begin to realize gains, typically in years five through 10, you start to see the distributions come off the portfolio, as represented by the teal bars.

Exhibit 1:
The J-Curve Pattern

Illustrative Annual Cash Flows for a Private Equity Partnership



Source: Lexington estimates. Presented for illustrative purposes only. There is no assurance that any estimate, forecast or projection will be realized.

The orange line represents the J-curve, showing cumulative net cash flow as it dips in the early years and rises in the later years of the fund. A secondary strategy can mitigate the J-curve effect and generally receives earlier distributions by acquiring interests in mature private equity investment funds that are later in the investment period (highlighted by the dotted line box in Exhibit 1). In this way, secondary investors are purchasing assets closer to their harvest stage and potentially at a discount to market value.

Attractive portfolio diversification

Secondary portfolios are typically broadly diversified by sponsor, fund, sector, strategy, geography, industry, company and vintage year. This broad diversification may dampen volatility, which can effectively reduce specific idiosyncratic risk of individual portfolio companies.

Reduced investment risk

By purchasing interests in private investment funds on the secondary market later into their PE lifecycles, secondary investors can typically see where most of the capital has been invested. In this way, the blind pool risk is mitigated. Blind pool risk refers to the potential uncertainties and risks associated with investing in a private equity fund without knowing the specific companies or projects the fund will invest in.

Secondary investors have fundamentally more information. An investor knows which companies are performing and which are not and is able to re-underwrite identified assets with an understanding of the macro environment in which they are investing. In this way, secondary investors can have better price discovery.

Global secondary market meaningfully undercapitalized

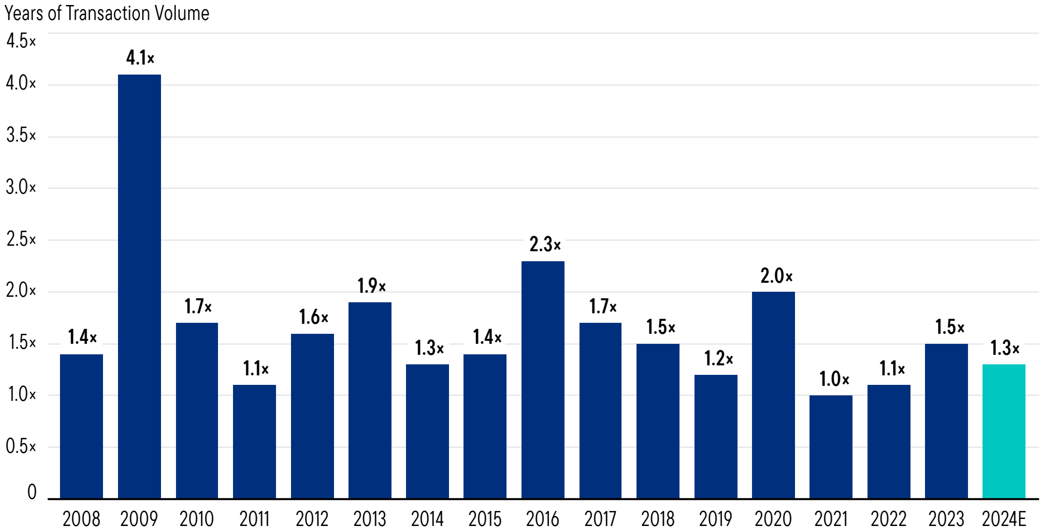
We believe there are attractive opportunities in today's secondary market for investors. There exists a supply and demand imbalance between the demand for liquidity in private investments and secondary buyer capital available to provide that liquidity. Secondary firms are positioned to fill this liquidity gap.

This shortage of secondary capital has persisted for much of the industry's existence—but is especially acute today (Exhibit 2). For example, the ratio above the bar representing 2024 is 1.3x, meaning just a little over one year of deal flow. This shortage of dry powder suggests that secondary buyers may have a pricing advantage in today's market.

Exhibit 2: Limited Liquidity in the Secondary Market

Secondary Dry Powder (Years of Transaction Volume)

2008–2024E



Sources: Lexington estimates (secondary transaction volume), Preqin (dry powder). 2024E reflects Lexington estimates as of October 2024. Years of transaction volume is based on end of year dry powder divided by preceding year deal volume. Bottoms up dry-powder analysis excludes dry powder for dedicated infrastructure and real estate secondary funds. Additional secondary capital raised is dependent on fundraising conditions over the near to medium-term. There can be no assurance that historical trends will continue.

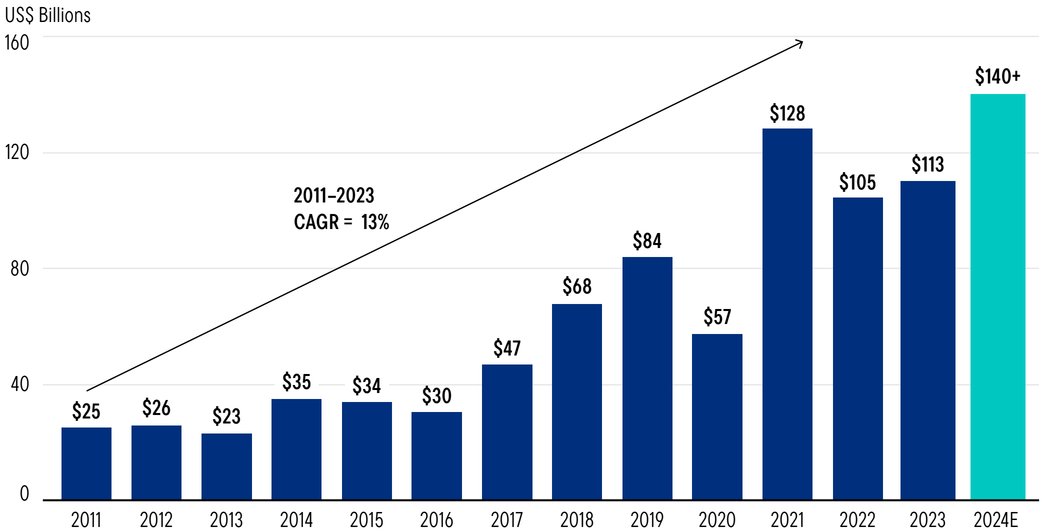
Growing inventory and increasing turnover drive secondary market growth

Active portfolio management of illiquid investments and the growth of GP-led transactions have driven the secondary industry's compounded growth rate of 13% per year since 2011 (see Exhibit 3).

Exhibit 3: Global Secondary Market Growth

Global Secondary Market Transactions Sale Price + Unfunded Commitments 2011-2024E

As of October 2024

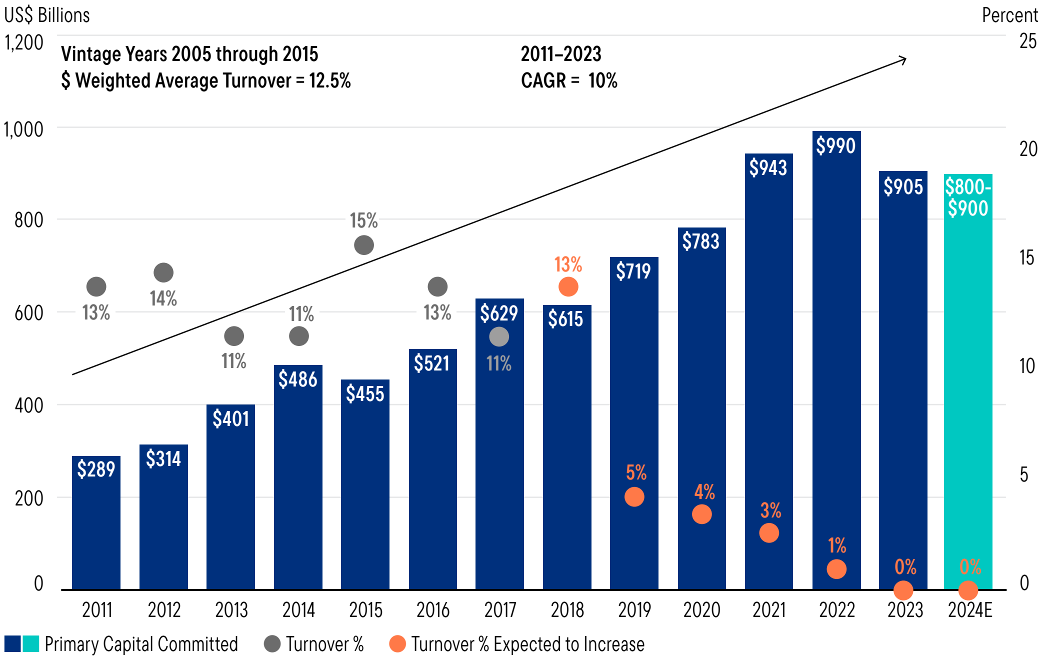


Sources: Dow Jones Private Equity Analyst/LP Source, Invest Europe, AVCJ, LAVCA, Preqin, and Lexington estimates. CAGR = Compound Annual Growth Rate. 2024E reflects Lexington estimates as of October 2024.

The secondary market has largely tracked the growth of the private equity industry, and we believe there is significant runway ahead. Exhibit 4 illustrates this dynamic. We can see the growth in fundraising in primary PE markets since 2011, compounding annually at 10% through 2023. Those assets are the inventory that eventually comprise the secondary market.

Exhibit 4: Future Vintage Years Indicate Potential for Solid Growth in Secondary Markets

Capital Committed to Private Investment Funds & Turnover %



Sources: Dow Jones Private Equity Analyst/LP Source, Invest Europe, AVCJ, LAVCA, Preqin, and Lexington estimates. CAGR = Compound Annual Growth Rate. Turnover percentages are based on Lexington estimates as of October 2024. 2024E reflects Lexington estimates as of October 2024.

The circles in the chart represent the turnover rate in each vintage year. The turnover rate represents the percentage of capital that has transacted in the secondary market from that year. For example, we can see in 2011 that $289 billion in capital was raised in that vintage year, and about 13% of that transacted through the secondary market. You can see the orange circles trend down and to the right, as turnover rate naturally increases as vintage years mature. The vintages on the right of the chart were raised more recently, and in fact are the largest vintages ever raised in the private equity market. These are not yet mature enough to see turnover into the secondary market. The expectation is that as these more recent vintages mature, there will likely be an increase in secondary volume over the next five to 10 years.

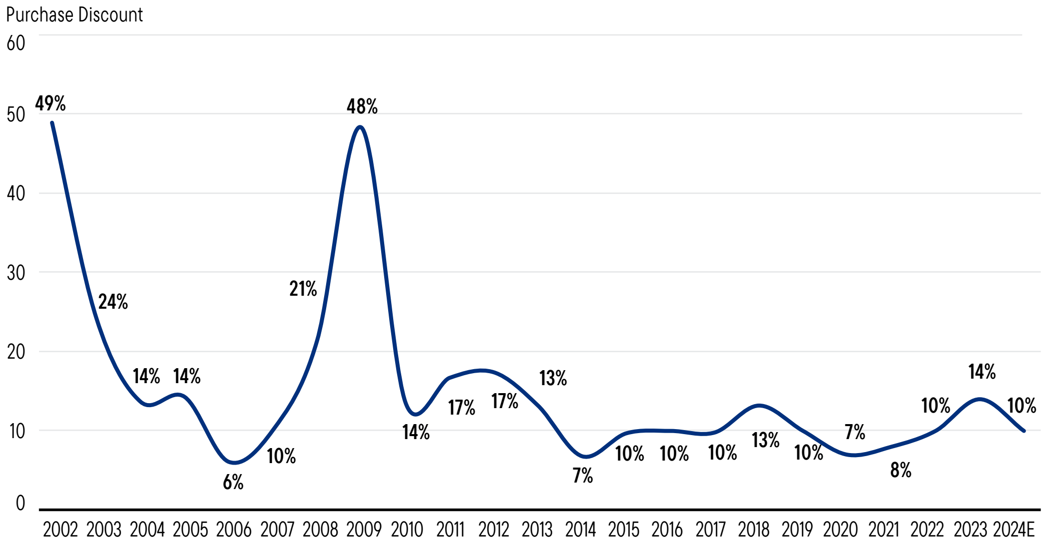
Recent uptick in discounts

Discount rates have been rather steady over the last 10+ years, but 2022 and 2023 saw elevated discounts (Exhibit 5). Factors driving the increase include recent market volatility and an expectation for declining net asset values (NAVs), which could result in more conservative underwriting by secondary buyers, and hence higher discounts. In addition, investors are increasingly seeking liquidity as portfolio distributions decline, so there is increased volume of portfolio sales as secondary industry dry powder reaches historic lows.

Exhibit 5: Secondary Pricing

Weighted Purchase Discount to Market Value

2002–2024E



Lexington estimates (database includes over 50,000 private equity and alternative interests). Presented for illustrative purposes only. There can be no assurances that projections will prove to be accurate, or that historical trends will continue. 2024E reflects Lexington estimates as of October 2024.

Discounts in the context of secondary PE markets

Given the long-term, illiquid nature of private investment funds, secondary firms may be able to purchase fund interests at a discount to market value. While a large discount does not necessarily signify an attractive deal, discounts may provide mitigation to the downside if values decline. Some factors that may contribute to secondary market discounts include market conditions, portfolio composition, and fund life stage.

The global secondary market has grown over the past three decades primarily as a result of the increased supply of capital committed to private investment funds, the trend towards more active management of these commitments, the desire among select investors for earlier liquidity, and the expansion of the sponsor-led opportunity set. In today's environment, LPs are seeking liquidity in the absence of distributions and are rebalancing portfolios versus allocation limits, while GPs are facing pressure to provide liquidity options to their limited partners. As such, we believe the backdrop for the secondary market continues to remain attractive.

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