A Liquidity Cushion in Troubled Times: The PE Secondaries Market

By Alexandra von Stauffenberg, Associate Director, INSEAD Global Private Equity Initiative

Even without deep discounts, secondaries' modest risks and returns are attracting investor interest.

The private equity (PE) secondaries market refers to the purchase and sale of existing stakes in PE investments, either limited partnership (LP) interests in funds or equity stakes in PE-backed companies. Secondaries offer owners of PE positions a path to liquidity and added flexibility in managing a portfolio of PE investments. It allows them to sell their stakes prior to fund dissolution or investment exit. Secondary buyers can access PE investments at varying stages of maturity, and obtain additional means of exposure to **specific managers and strategies**.

For insights into opportunities in the secondaries market triggered by the economic impact of the global pandemic, we spoke to two INSEAD alumni with extensive experience in the market working at leading secondaries firm Coller Capital – Francois Aguerre (INSEAD MBA '05D), Partner and Co-Head of Origination, and Katrina Liao (INSEAD MBA '11J), Investment Principal – in a recent webinar. "**Private Equity: Insights Into the Secondaries Market**" was moderated by INSEAD Professor **Claudia Zeisberger**.

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The growth of the secondaries market

The overall private capital industry has grown significantly over the last 20 years. Assets under management (AUM) have grown more than tenfold, from US$647 billion in 2000 to **$4.8 trillion in 2019**. This growth is driven to some extent by the strong performance of some primary PE funds. Zeisberger mentioned that whilst in the 1980s the PE market was still very much a cottage industry, those days are long gone. If anything, over the last 15 years, it grew significantly faster than the public equity market.

The PE secondaries market has grown in line with the primary market. The key reasons are that secondaries allow investors to achieve liquidity early, rebalance their portfolios, modify exposures due to regulatory changes ‒ as we saw after the last global financial crisis ‒ and also lock in returns on their private equity investments.

Nonetheless, there is a large gap between the primary and the secondaries markets. According to Liao, one factor is the various growth areas in the primary market – such as credit, infrastructure and energy – which historically didn't have secondary markets. Secondary markets have only begun to develop in those industries. When looking at the more traditional PE industry only, secondaries are keeping pace, if not outpacing, the growth of the primary market.

However, Aguerre highlighted that it is still very early days for the secondaries market. “It's very rare in any private market that the secondary market would be only a few percentage points of the overall illiquid market, which is where we are today in the context of private assets. I think the catch-up we're talking about, it's not a catch-up of the next couple of years. There will be a proper catch-up when the industry is at least north of $500 billion a year, and we were last year only at $85 billion. So there's massive growth still to come.”

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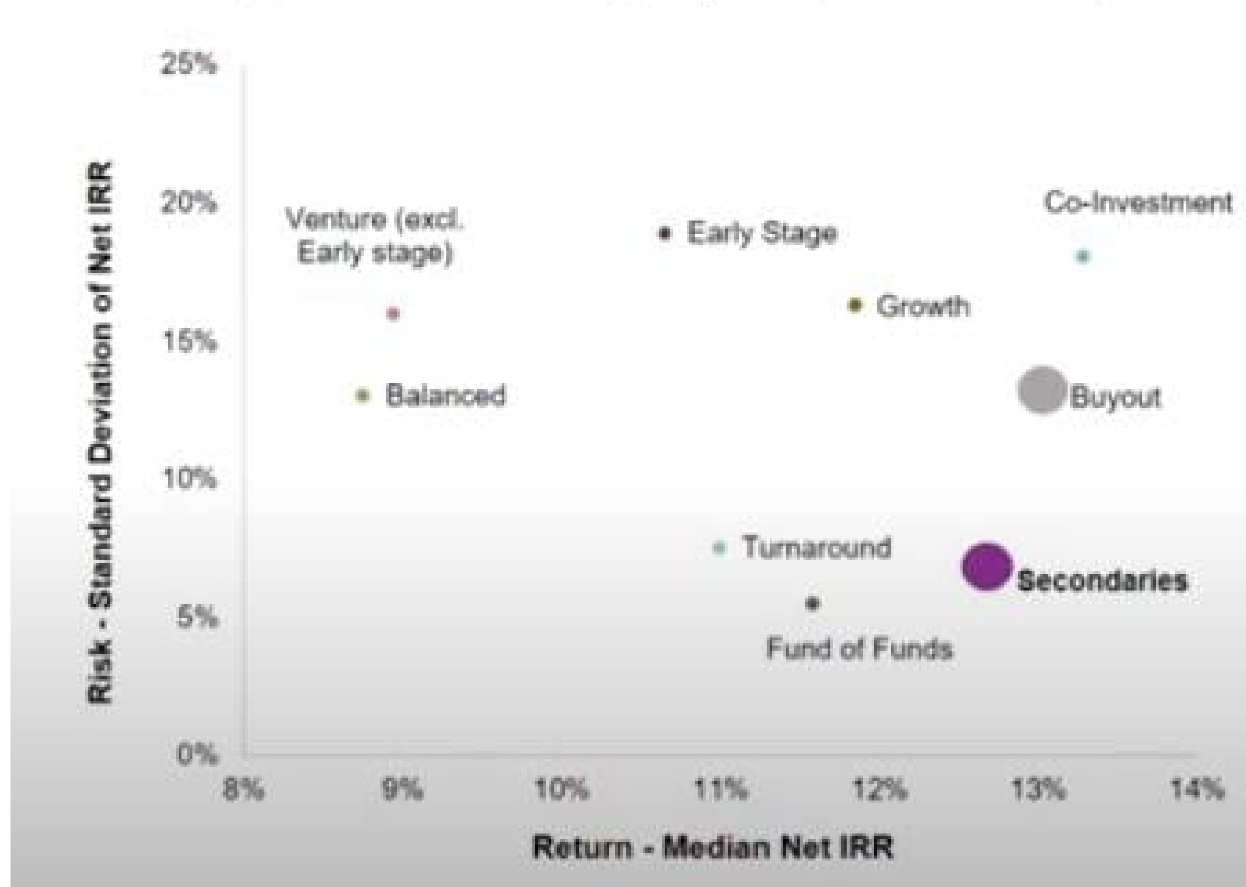

When looking at the risk/return profile of the different PE strategies – standard deviation and median of the net IRR numbers – secondaries are in the lower quartile in terms of riskiness, but clearly have managed to achieve interesting returns.

Secondary sellers and buyers

Traditionally, secondaries were very much focused on LP interests. If an LP wanted to step out of a primary PE fund early, the only way they could achieve this kind of liquidity was through a secondary transaction. Now, the secondaries market is being utilised by a variety of other participants, such as General Partners (GPs), who use it to provide liquidity to their LPs from their portfolio.

The seller of secondary assets can be any PE investor. According to Liao, on a larger scale, the sellers are typically public pension plans, sovereign wealth funds, financial institutions, insurance companies or asset managers,

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because they have invested substantially in the PE market. On a smaller scale, there are also family offices, foundations or corporate pensions.

The buyer universe on the other hand is still relatively concentrated. Liao cited anonymised data from the banking advisory firm Evercore which showed that around half of the transactions in 2019 were completed by only six players. The top 80 percent of the market by volume consists of only 15 players.

Opportunities in times of crisis

The main reason for an investor to sell during times of market distress is liquidity. In such circumstances, investors may need to adjust their portfolios. Selling assets when valuations are down is a trade-off between how much investors need the cash vs the loss incurred.

When asked if the current market downturn brings new opportunities for the secondaries market, Aguerre mentioned that one benefit of the secondaries markets compared to the buyout market or other strategies is that activity is always ongoing. “When investing in buyouts, probably now is not the time to sell assets, because it will be challenging to optimise exit values in times of depressed valuations, and therefore, there is not much activity going on from a transaction perspective. On the secondary side, however, because there are always liquidity needs somewhere in the market, even though you end up with a slightly lower volume, you still have opportunities.”

During and after the 2008 financial crisis there were tremendous investment opportunities which delivered outsized returns in the secondaries market. According to Aguerre, the investment horizon of these opportunities lasted up until early 2012.

However, he highlighted that it is important to understand that today’s crisis is very different at this stage from the last crisis, even though the consequences may be similar. Back in 2009, listed equity markets were down around 50 percent peak to trough, but businesses were still mainly functioning. Today, the market is only around 15 percent down from the top, but economic activity has stopped to a large extent. Hence, Aguerre explained that the adjustment of valuations is a very different matter today because what matters is not only the discounts, but rather which metrics to use when there is great uncertainty about the underlying business plans for assets. Notwithstanding, in this market situation, you wouldn’t buy

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secondary assets at prices similar to yesterday’s.

Alexandra von Stauffenberg *is the Associate Director at the INSEAD* ***Global Private Equity Initiative****.*

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About the author(s)

Alexandra von Stauffenberg Alexandra von Stauffenberg is the Associate Director of INSEAD's Global Private Equity Initiative (GPEI), the school's think-tank for private equity and venture capital.

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