THE GLOBAL SECONDARY MARKET:
A Growing and Evolving Investment Opportunity
INTRODUCTION

The secondary market saw its earliest transactions occur in the mid-1980s, when the broader private equity (PE) asset class was still relatively unfamiliar to many institutional investors. Today, the secondary market is comprised of more than $40 billion of annual transaction volume, with hundreds of sellers.¹ The secondary market represents an important part of the global PE market because of the liquidity it offers institutional investors, the strategic value it can offer to general partners (GPs), and the investment opportunities it provides to secondary buyers and their investors.

The market’s evolution to date has been characterized by both its growth and its increasing degree of sophistication. Looking ahead, the market is expected to continue to grow in both size and complexity given the growth in the global PE market, the value institutional investors place on liquidity, and the continued introduction of innovative liquidity solutions.

WHY INVEST IN SECONDARIES?

Generally, investing in the secondary market can provide several benefits, including:

> **Compelling risk/reward profile** – secondary investments may offer investors the opportunity to earn compelling rates of return while assuming less risk than other PE strategies. This dynamic is due to the shorter duration, quicker payback period, diversification, and lack of blind pool risk typically associated with secondary investments relative to other strategies.

> **Accelerated capital deployment** – secondary funds may have a more compressed draw-down period relative to primary funds, which allows capital to be invested more quickly. This feature may be particularly helpful to investors looking to increase their exposure levels to the asset class in a shorter time frame.

> **Near-term liquidity** – given the maturity of the underlying assets in most secondary transactions at the time of purchase, secondary investments often have the potential to generate early distributions.

> **J-curve mitigation** – unlike primary funds, secondary funds may have the potential to generate strong performance in their early years as a result of the unrealized gains that may be associated with buying assets at a discount.

> **Purchasing at a discount** – PE assets are illiquid by nature and generally sold in private, negotiated transactions. Some sellers in need of liquidity may be willing to sell for less than the fair value of the investments in exchange for the ability to quickly monetize their private equity assets. As such, secondary purchases may take place at a discount to fair value.

> **Immediate portfolio diversification** – secondary funds typically provide diversification across stage, industry, and geography. These funds are also unique in their ability to provide investors with access to underlying partnerships with vintage years that are five to 10 years old, or more. This dynamic provides an opportunity for investors who may be new to the asset class to gain immediate exposure to a seasoned PE portfolio.

MARKET GROWTH

As a subset of the global PE market, the secondary market has experienced particularly strong growth over the last decade (see Chart 1). Over this time period, the secondary market’s growth has significantly exceeded that of the primary market as a result of an increase in the turnover ratio of limited partnership interests, the broader acceptance of the secondary market as a portfolio management tool, and the increasing array of transactions that have resulted from investors’ overarching desire for more liquidity in what is otherwise an illiquid asset class. In addition, secondary market activity often increases during periods of distress and economic dislocation.

Going forward, we expect to see continued growth due to several trends:

> Financial institutions continue to divest assets in order to comply with post-Global Financial Crisis regulations related to illiquid assets and risk-weighted capital.
> Pension funds and other institutional investors use the secondary market as a tool for refocusing their portfolios and consolidating manager relationships.
> Sovereign wealth funds with increasingly mature PE portfolios are becoming more active sellers.
> Whole fund liquidity solutions continue to rise in popularity.

> CHART 1
MARKET GROWTH FUELED BY PRIMARY MARKET
Source: Thomson Reuters, Cogent Partners

Future Growth

One of the faster-growing segments within the broader secondary market is the global real assets sector, which includes energy, power, infrastructure, natural resources, and real estate. Over the past decade, the sector has seen significant increases in capital raised, number of active managers, and in the breadth and complexity of strategies deployed. Investors are attracted by the unique benefits these assets provide, including a stable yield component, inflation linkage, and diversification.

In the energy sector, for example, the underlying net asset value (NAV) of investments with more than five years of maturity has grown from $11 billion to over $70 billion in the past five years, with a projected market size of $100 billion or greater by 2017. A similar trend exists in the infrastructure sector, where we have seen a threefold increase in the amount of NAV that is more than 5 years in maturity, growing from $50 billion in 2012 to over $100 billion in 2014. HarbourVest believes that the market size should continue to increase to over $150 billion or greater by 2017.

EVOLUTION OF DEAL TYPES

GEOGRAPHIES
The profile of secondary assets for sale is constantly evolving, as are the types of transactions that are completed. Geographically, U.S.-based assets account for the largest share of deal volume (see Chart 2). This is consistent with the relative size of the U.S. PE market where buyers have an especially strong appetite due in large part to high confidence in the U.S. market. European deal flow is also generally consistent with the relative size of the European PE market, although transactions in Europe have been skewed toward more complex opportunities. The secondary market in Asia continues to grow and introduce new transaction types. Lastly, emerging market secondaries remain relatively nascent, as those markets continue to develop and grow.

TYPES OF TRANSACTIONS
The evolution of the types of transactions that comprise the overall secondary market is one of the market’s defining trends.

The secondary market of the 1980s and 1990s was comprised almost entirely of traditional transactions (i.e., the purchase of one or more limited partnership interests by a buyer from a single seller). While traditional transactions continue to account for a majority of secondary market activity, the market has evolved to include a broad range of transactions that provide holders of PE interests with liquidity options through increasingly sophisticated deal types (see Chart 3).

Buyers have an especially strong appetite due in large part to high confidence in the U.S. market.
Correspondingly, some secondary buyers have shaped their investment strategies to reflect this market shift. While many buyers have remained focused on the traditional part of the market, a limited number of participants have developed a focus on the non-traditional, or complex, transaction types. As a result of this dynamic, while the traditional end of the market has experienced increased levels of competition over time, there tends to be greater inefficiency with respect to more complex transactions.

As indicated in Chart 4, there is a range of transaction types that comprise the complex end of the secondary market, including:

> **Captive investment team spin-outs:** A secondary buyer purchases a portfolio of direct company investments with a newly formed acquisition vehicle, which includes customized governance and economic terms; the incumbent portfolio manager responsible for managing the assets on behalf of the seller departs (spins out from) the seller and becomes the independent manager of the newly formed vehicle.

> **Whole fund liquidity solutions:** A secondary buyer partners with a GP to offer a broad-based liquidity solution to a fund’s limited partner (LP) base, often in conjunction with amending the governance and economic terms of the fund in order to better align the GP and the LPs.

> **Public-to-private transactions:** A secondary buyer provides a liquidity solution to shareholders in a publicly traded vehicle holding a portfolio of PE investments, either through a tender offer or asset sale.

> **General partner-for-hire transactions:** A secondary buyer purchases a portfolio of direct company investments with a newly formed acquisition vehicle, which includes customized governance and economic terms; a new manager is identified to manage the newly formed vehicle.

> **Other customized solutions:** A secondary buyer may develop a tailored liquidity solution that addresses the objectives of a seller when such objectives cannot be satisfied with a traditional sale.

The assets acquired in complex secondary transactions are often similar to or the same as those involved in traditional transactions. Accordingly, they should not be viewed as having a different risk profile from the underlying assets involved in traditional deals.

However, complex transactions typically require differentiated skill sets and/or resources to successfully execute. They often have more complicated negotiating dynamics than the bilateral negotiations commonly associated with the purchase of traditional assets where the only variable is price/discount. Many complex transactions, for example, require the creation of newly formed entities with customized governance and economic provisions. Additional legal, tax, and reporting hurdles also need to be addressed as part of the structuring and execution process; but above all, they are generally more resource-intensive, require more time and patience to execute, and typically carry more execution risk.

These factors cause many secondary buyers to focus predominantly or exclusively on the traditional segment of the secondary market. Thus, buyers with the requisite resources, experience, and skill sets will be in a better position to take advantage of the lower levels of market efficiency and competition associated with the complex end of the market.
SECONDARY BUYERS

The secondary market generally includes three types of buyers. The first type is a dedicated secondary buyer whose sole or predominant focus is secondary investing. This segment of the buyer community includes both small and large players, and they generally bring strong evaluation and execution skills due to their experience and team resources. Given their exclusive or heavy focus on secondaries, they might not have the depth of relationships with GPs that typically only come with having primary capital.

The second type of buyer is one that is part of a broader platform, where secondary investing is complemented by other investing activities such as primary or co-investment. This segment of the buyer community also includes small and large players with strong evaluation and execution skills. Buyers in this segment may also bring the added benefit of having valuable relationships with GPs due to the strategic value they bring as primary fund investors.

Last, the third type of secondary buyer is an institution that does not have a dedicated secondary program, but may participate in secondary transactions opportunistically. This buyer segment is generally characterized as having fewer resources and is more likely to focus on purchasing fund interests in managers that are familiar; they also tend to focus predominantly on modestly sized or smaller traditional secondary transactions.

Secondary investors have benefited from investor demand for secondaries, which has enabled the established players to raise meaningful pools of capital. While the supply of capital to complete secondary transactions has grown, secondary buyers have continued to find an abundance of investment opportunities through which to deploy that capital. As shown in Chart 5, while secondary buyers have raised a total of $93 billion since 2011, they have invested $160 billion over that same time frame. This would suggest that there continues to be a supply and demand imbalance that favors secondary investors with capital to invest.

As a result of a strong fundraising market, secondary funds hold an estimated $55 billion in dry powder, the unspent committed capital held by dedicated secondary funds. While this is significant, at last year’s investment pace of $40 billion this would be sufficient to fuel only 1.4 years of deals. Moreover, it is relatively small compared to the massive $1.3 trillion in dry powder for the entire private equity asset class and $460 billion in total capital targeted for buyouts.

There continues to be a supply and demand imbalance that favors secondary investors with capital to invest.

CHART 5
AGGREGATE SECONDARY CAPITAL RAISED AND DEAL VOLUME

Source: Preqin Secondary Market Monitor, UBS, Cogent

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SECONDARY SELLERS

WHO IS SELLING AND WHY?
Sellers in the secondary market represent a broad cross-section of the institutional investor community, reflecting growing acceptance of the secondary market across a wide range of investor types (see Chart 6).

Looking at 2015 sales activity, the most active sellers were public/private pensions and sovereign wealth funds (SWFs), which together accounted for more than a quarter (26%) of all secondary sales volume. SWFs in particular have become significant primary investors in PE over the last five to 10 years. As more SWFs enter the asset class, and as those with existing portfolios look to the secondary market as a tool for rebalancing and refocusing their portfolios, they are likely to account for an increasing percentage of secondary market activity. Given the size and quality of the PE portfolios held by many SWFs, they are expected to be a driver of high-quality deal flow going forward.

Endowments and foundations were also active sellers in 2015, accounting for 24% of all sales volume. Many of these LPs sold with a dual goal of reducing their non-core GP relationships and accelerating the repositioning of their portfolios.

The next most active group of secondary sellers was GPs, which represented 15% of all sales volume in 2015. Increasingly, GPs – particularly those with funds reaching the end of their 10-year terms – are open to collaborating with secondary buyers to provide liquidity to their investors and in some cases resetting management fees, carried interest, and governance terms. These types of whole fund liquidity solutions are discussed in more detail on page 7.

Secondary buyers have become increasingly attracted to top-tier GPs/funds which they believe can offer lower downside risk.

PRICING TRENDS

MACRO DRIVERS
While annual pricing remained strong in 2015, secondary pricing differed significantly from the first half of the year to the second (see Chart 7).

Overall, the average high bid across all strategies reached 90% of NAV for the second straight year as reported by Greenhill Cogent based on the sale processes they managed in 2015. Continuing the trend witnessed in prior years, buyout funds generated the highest demand and pricing, averaging 94% of NAV.

A close look at second-half pricing trends, however, shows a broad decline in secondary pricing across all strategies, due in part to ongoing global market volatility and economic uncertainty. In the face of these macroeconomic headwinds, pricing for all secondary strategies fell to 88% of NAV.

In viewing Chart 7 it is important to keep in mind that while the data is helpful in highlighting directional changes in pricing, because it is based on intermediated sale processes, it by default represents pricing in more competitive deals – the intermediated and publicized deals – that took place in 2015. By contrast, secondary trades that were not a result of a competitive auction process might have resulted in lower pricing levels due to lower levels of intermediation.

We are also witnessing a growing pricing/demand gap between high- and low-quality assets. Against the backdrop of uncertainty, secondary buyers have become increasingly attracted to top-tier GPs/funds that they believe can offer lower downside risk. At the same time, interest is declining for funds with high single-company concentration, GP franchise concerns and/or portfolios with meaningful public market holdings.

WHOLE FUND LIQUIDITY SOLUTIONS

The latest phase in the evolution of secondaries as it relates to the role of the GP is the emergence of GP-led secondary transactions that provide a liquidity option to the entire LP base of a given fund. These transactions, referred to as whole fund liquidity solutions, have recently become one of the fastest-growing segments of the secondary market (see Chart 8). In these transactions, a liquidity solution is offered simultaneously to all investors in a fund later in its life, typically as part of a coordinated process involving both the fund’s GP and a secondary buyer. The GP-led aspect of these transactions is what differentiates them from other secondary transaction types.

A growing universe of GPs is beginning to contemplate the use of whole fund liquidity solutions as a means for:

> Providing existing investors with a liquidity option
> Potentially addressing GP/LP alignment issues that may exist later in the life of a given fund through economic and governance changes
> Enhancing value creation potential by securing incremental capital

GENERAL PARTNERS & SECONDARIES

Over time, GPs have taken greater interest in the secondary market because of the implications it can have with respect to their LP bases. In nearly every secondary transaction, GP consent is required for approval. Some GPs have used this consent right as a means for helping to softly direct secondary positions to institutions that they consider preferred buyers (typically buyers that have the potential to support the GP in its next fund).

 Buyers often look to GPs to provide the names of institutions that may consider selling as a means for generating deal flow. More importantly, buyers rely on obtaining the insights and projections from GPs about their portfolios as a key source of information used in pricing and evaluating secondary opportunities. In this regard, those secondary buyers with the strongest GP relationships are generally best positioned to access the most valuable information.

> CHART 7
SECONDARY PRICING
Source: Greenhill Cogent, January 2016

> CHART 8
PROJECTED WHOLE FUND LIQUIDITY SOLUTION MARKET OPPORTUNITY
Source: Credit Suisse, January 2015
As this subset of the secondary market began to emerge three to five years ago, certain challenges associated with such deals also emerged. First, the market perceived these transactions to be associated with managers that might otherwise have difficulty raising future pools of capital. Today, the quality of GPs has broadened to the point where managers that were oversubscribed in their most recent funds have successfully executed whole fund liquidity solutions as a means for providing broad-based liquidity solutions to the LP bases of their older funds.

From the LP perspective, one of the early and often troubling aspects of whole fund liquidity solutions was the lack of a status quo option. In other words, LPs may have been given options to sell (at a discount) or to accept a revised set of fund terms, but they were not always given the choice to simply stay put and live with the terms of the deal they had signed up for at the fund’s inception. Today, the market has evolved to the point where most, if not all, whole fund liquidity solutions include a status quo option, or something that strives to replicate the status quo. This positive development has facilitated the acceptance of these transactions and helped ensure the fair treatment of existing investors that may not be interested in the liquidity option offered to them.

Although this market segment is still evolving, secondary buyers with the experience and resources to successfully source, screen, and execute in this part of the market may be well positioned to capitalize on its rapid growth.

WHOLE FUND LIQUIDITY SOLUTIONS: FIVE KEY CONSIDERATIONS

> **Manager quality:** Has the GP successfully raised a new pool of capital in the last five years? If not, what is the confidence level in the current team’s ability to raise capital in the future?

> **Asset quality:** What is the current profile of the underlying portfolio, including operating performance, capitalization, and risk? What are the prospects and expected timing for portfolio company exits?

> **LP/GP alignment:** Are the fund’s original economic and governance provisions providing an appropriate alignment of interests between the LPs and GP today, or would all parties benefit from changes to the original fund terms in order to improve the alignment of interests?

> **Pricing/seller appetite:** What is the profile of the LP base, and are LPs interested in a liquidity option at a price that will deliver an attractive return to the buyer?

> **Structure:** What is the optimal structure for offering LPs both liquidity and status quo options? Will LPs be offered the opportunity to sell their interests, or will the fund be offered the opportunity to sell its underlying companies? Will new capital be made available to the GP?
SUMMARY

For more than 30 years, secondaries have served as a key lever for institutional investors to balance and diversify their PE portfolios as well as mitigate the effects from the J-curve. Looking ahead, we believe the key drivers are in place for continued secondary market growth and investment opportunity. If recent past is prologue, sellers will continue to look for new liquidity solutions and the market will continue to introduce new, innovative strategies designed to meet the needs of sellers, buyers, and GPs, resulting in growing and diverse future deal flow.
CASE STUDY #1: PROJECT BELL

**Description:** In 2013, HarbourVest acquired limited partnership interests representing 54% of the total commitments to Motion Equity Partners Fund II; we also provided capital to the manager for a new vehicle.

**Transaction type:** Complex, GP-led whole fund liquidity solution

**Exit:** The largest company in the portfolio, Diana Group – a global natural ingredients supplier for the pet food and food and beverage industries – was sold to Symrise (closed on August 2014)

**Seller:** Multiple LPs

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HARBOURVEST'S GLOBAL PRIVATE MARKETS PLATFORM VALUE ADD

- **Leading provider of comprehensive liquidity solutions** – HarbourVest became the preferred provider for the whole fund liquidity solution based on its track record in putting investor capital to work to provide efficient and equitable options for LPs and new structures for GPs.

- **Deep diligence and multi-market perspectives** – as an experienced investor across the primary, secondary, and co-investment channels, HarbourVest was in an advantageous position to understand the underlying assets, evaluate the team’s ability to unlock value, and leverage information available from its large GP network to better inform its investment case.

- **Organizational experience and scale** – HarbourVest utilized its experience to successfully complete individual negotiations and documentation with 37 institutions holding 49 limited partnership interests, as well as structure an extension vehicle, all within an accelerated time frame.

**BENEFITS TO HARBOURVEST INVESTORS**

- **Access to an attractive portfolio with short duration** – HarbourVest investors gained a timely opportunity to secure a mature, diversified portfolio that can be realized over the near- to medium-term.

- **Franchise value and future deal flow** – our first-mover advantage in structuring bespoke, innovative liquidity solutions positioned investors to benefit from future deal flow.

- **Risk control and comfort** – HarbourVest’s experience, skill sets, and infrastructure provided its investors with substantial comfort and downside risk protection in executing the innovative fund liquidity solution.

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The deal summary, general partner, and/or companies shown above are intended for illustrative purposes only. While may be an actual investment or relationship in a HarbourVest portfolio, there is no guarantee it will be in a future portfolio.
CASE STUDY #2: PROJECT CHARLOTTE

Description: In 2012, HarbourVest purchased the private equity investment portfolio of Conversus Capital L.P., a Euronext-listed investment company. HarbourVest is managing the run-off of the portfolio on behalf of its funds and rolling Conversus unit holders.

Transaction type: Complex, public-to-private

Seller: Conversus Capital, L.P.

HARBOURVEST’S GLOBAL PRIVATE MARKETS PLATFORM VALUE ADD

> Market knowledge and fund manager relationships – market intelligence and extensive GP relationships enabled HarbourVest to efficiently due diligence and transfer a substantial portfolio of over 200 funds managed by nearly 100 GPs, with over 2,000 underlying companies.

> Navigating complexity – as both a fund investor and a manager of its own listed vehicle, HarbourVest had the unique experience and capabilities to structure a highly attractive solution for investors by providing both a cash and rollover option, thereby addressing the desires of a diverse shareholder base.

> Large investor with streamlined decision-making – HarbourVest’s scale and deal experience enabled it to quickly consider and then fully underwrite what was a sizable and highly complex transaction.

BENEFITS TO HARBOURVEST INVESTORS

> Access to a pre-eminent deal – our investors were able to gain exposure to a large and innovative transaction involving a portfolio of assets managed by high-quality GPs.

> Future deal flow – by demonstrating the ability to identify, unlock, and execute on a large, complex secondary transaction, HarbourVest investors stood to benefit from future secondary opportunities.

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