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The secondary market as an active portfolio management tool

By Charles Soulignac of Fondinvest Capital

Why was there no surge in secondary deals in 2009?

The economic crisis of 2008 and 2009 has had a huge impact on financial institutions, affecting banks, insurance companies, pension funds, endowment funds and even family offices. But since 2007, contrary to all expectations, the amount of secondary deals completed has continued to decrease, reaching some $8.8 billion last year, versus $16.4 billion in 2008.

Few investors during the recent downturn have faced liquidity problems serious enough to warrant secondary sales, while no major institutional investors have had to seek support from their respective governments. In fact, many institutional investors have resisted selling their private equity assets to avoid suffering significant losses.

Declining asset values as well as the low profile of secondaries in the marketplace have fostered a growing expectation gap between buyers and sellers. Many secondary buyers were offering heavily discounted prices and expecting transactions to close, even if their prices were unrealistic. As a result, in many cases only the most desperate vendors managed to close secondary deals while many disposals have been held up.

Moreover, institutional investors have faced strong market volatility, resulting in a lack of capacity to adopt a clear strategic positioning toward their private equity allocations. With alternative assets representing just a small portion of their balance sheets, most restructuring efforts by institutional investors were focused on their core activities, while their private equity portfolios were placed on hold.

Are early secondaries now becoming a key area of interest?

Initially dedicated to the buying back of fund interests, the secondary market has gradually been extended to offerings of shares in direct investment portfolios and tail-end funds. Since the end of 2008 and throughout 2009, the market has evolved further with the increasing prominence of early secondaries, or limited partner interests in funds less than 50% invested.

Prompted by that development, some private equity teams have performed a detailed analysis of their assets with a strategic view beyond that of seeking liquidity alone. In fact, some large institutional investors have reduced the number of general partners in their investment portfolios and sold their interests in early secondary funds.

On the seller side, this kind of transaction can be advantageous. Rather than selling funded positions at distressed prices, LPs can dispose of lightly funded positions and minimize the impact of the loss.

On the buyer side, the assessment of early secondary interests is fundamentally different from the evaluation of mature secondaries. Because they contain a large portion of unfunded commitments, assets remain “blind investments” with a high level of uncertainty regarding capital deployment, so predictions on assumed returns can be very challenging.

Early secondary transactions can be an attractive way for sellers to avoid deploying capital in certain funds. For buyers, however, such deals can prove very risky if said buyers have not acquired an in-depth knowledge of the GP in question.

But do early secondaries really refer to secondary assets? Such deals have much more to do with primary commitments, both in terms of analysis and in terms of their returns profile.

Secondaries: an active portfolio management tool

If the search for liquidity was long the main driver for the secondary market, the motivation of investors considering a divestment of their interests have changed significantly over the last few years. It looks like the “buy-and-hold” model for private equity fund management is over, while LPs now consider the sale of secondaries as a way to efficiently manage their portfolios.

The evolution of LPs’ views of the secondary market shows the interest they have in private equity in general, and in particular its capacity to deliver stronger performance over a long period of time, as compared to other asset classes.

LPs are now proactively managing their private equity investments in much the same way they do for other asset classes like quoted equities, fixed income or real estate. Sales are motivated by strategy, done in order to optimize or rebalance private equity portfolios to focus on higher returns.

As a consequence, when seeking opportunities, buyers are increasingly taking the seller’s strategic view into account. However, they may experience declining performance when the sales are not forced by liquidity needs.

Charles Soulignac is the founder and managing partner of Fondinvest Capital. He joined CDC Participations as an associate in 1989, where he managed investments in private equity funds and direct equity investments. He also has previous experience in industry (Potain), consultancy (Maynard) and finance (Bred). He started the funds-of-funds business in 1994. He has been a member of the European Private Equity and Venture Capital Association’s board of directors and investor relations committee.