Disciplined Strategy for a Newly Efficient Secondary Market

Only a decade or so ago, the secondary market for interests in private investment funds was a side street – an avenue of investing poorly understood and little traveled. Today, it is a bustling, seemingly frenetic boulevard where billions of dollars in capital raised is seeking attractively priced existing interests in ongoing private equity funds. The trade press is brimming with accounts of the latest secondary manager to raise a multi-billion-dollar fund or large public pension fund launching its own secondaries program.

Secondaries have indeed "arrived." The market's maturation and the throng of new players, however, make it ripe for missteps, excessive expectations, pricey assets, and disappointment. To operate successfully in today's crowded private investment secondary market takes discipline, fresh thinking on asset valuation, and an understanding of market cycles. A secondary can have quite different characteristics from a new, or "primary," interest in a private equity, venture capital, private realty, or natural resources fund. With a primary interest, a limited partner (LP) typically places capital into a fund managed by a general partner (GP) and expects outsized profits in return for agreeing to lock the money up for a decade or more. The secondary market allows the same LP to cash out of its illiquid interest in the private investment fund (the reasons abound, but a need for cash is often paramount). When an LP sells his interest, the buyer of this secondary hopes to have acquired an attractive portfolio of more mature assets, often at a discount to net asset value. During the buyout boom of the mid-2000s, secondaries began to evolve from a niche within the private equity market to an active strategy with a burgeoning set of buyers and sellers.

We say secondaries have "arrived" largely because more participants in the market have come to understand the attractive nature of these more mature private equity interests. It certainly helps that overall returns for secondaries have been generally strong. If buyers of secondaries have purchased intelligently, they gain a faster path to liquidity and to potential profit. The purchaser of a primary interest, in effect, invests in a blind pool, not knowing what assets will ultimately fill the void. Secondaries, on the other hand, offer greater visibility into the underlying assets, as well as shorter hold periods. In addition, the secondary buyer bypasses the initial burden of private equity's J-curve, where fees take a toll in the early stages of a fund and distributions dominate the middle and latter years.

Of course, the recent mainstreaming of the secondary market means that the outsized risk- and liquidity-adjusted returns enjoyed over the past decade should not be expected in today's market. For now, at least, competition for buyers is fierce, seller expectations are high, and, therefore, secondary pricing is heady. Because of TIFF's repeated efforts in recent months to discover attractive prices as a potential buyer and seller, we believe we have as clear an understanding of the current secondary market dynamic as anyone. We also know that today's market will continue to evolve and there will certainly be better buying opportunities at some point.

Over the past two years, for example, TIFF has seen pricing for high-quality funds on the secondary market (four- to six-year-old funds of highly regarded GPs) increase dramatically, starting from discounts as deep as 10-20% of NAV ballooning to premiums of 0-5% to NAV. Even lower-quality GPs and tail-end funds (partnerships that are often 10 or more years old and contain few remaining assets) have increased in price. Furthermore, it is our view that the quality of the funds sold in the market in 2013 generally declined from previous years, with more sellers unloading tail-end funds and those funds managed by GPs with whom they no longer plan to invest (a form of portfolio rebalancing). Overall, the market is seeing higher prices for lower-quality assets.

We see three broad reasons that pricing is generally unattractive today and competition is meaningful. The first is, as we've noted, the increase in capital allocated to secondaries. We have seen what we believe to be reliable estimates that secondary funds raised some $35 billion over the past two years and are likely to raise perhaps another $25 billion in 2014. These figures exclude capital from large pension and sovereign wealth funds that have waded into the space with deep pockets and a lower required rate of return than typical secondary buyers. This means "dry powder" in the secondary arena is very substantial. Secondly, supply issues have led to poor deal dynamics. Unfortunately for the capital chasing secondary transactions, sellers are not particularly motivated to sell today. Part of this is cyclical in nature. During and coming out of the financial crisis, many institutions were above their allowable private equity allocations and needed liquidity, so they felt pressure to sell their LP interests. Sellers were motivated, and secondary buyers had the upper hand. The strength of financial markets over the past four years has shifted power away from secondary buyers and back to sellers. Mergers and acquisitions (M&A) and initial public offerings (IPOs) have returned cash to investors, easing liquidity concerns. Also, rising equity prices have taken pressure off of over-allocated private equity investors.

Market maturation is the third issue affecting recent pricing shifts. All of the activity and interest in the secondary market has led to greater sophistication among buyers and sellers. The cultural shift surrounding secondaries has changed dramatically over the past five years. While selling LP interests was once considered a last resort for desperate sellers, secondaries are now generally accepted by LPs and GPs alike. Most GPs now view secondaries as a standard part of the business. While LPs previously sold funds only in times of financial stress, some now use secondaries as a portfolio rebalancing tool. Many specialized intermediaries and brokers have sprouted up in the last several years, resulting in more contested secondary transactions, better information flow, and a more educated seller base. While the secondary market remains less efficient and more opaque than most parts of the investment world, efficiency and capitalization are on the rise.

Given the amount of capital many secondary funds must put to work due to their recent major fundraising efforts, they have needed to supplement their traditional deal flow (acquiring single funds or portfolios of funds) by pursuing less-traditional transactions. Many secondary buyers have branched into realty fund secondaries, hedge fund secondaries, and secondaries in other less-trafficked areas in which their teams may not have experience. Many buyers, for example, are putting increased amounts of capital into direct secondaries, or the purchase of individual private companies from existing shareholders. The most popular new area of deal flow has been the recapitalization of “zombie” funds – 10-plus-year-old funds managed by GPs unable to raise new capital and complete new investments since the mid-2000s. Here, a secondary buyer will create a new special-purpose vehicle (SPV), which one or many secondary buyers capitalizes, and purchase all remaining assets in the “zombie” fund, often at or near 100% of NAV. The original LPs are bought out, at times even forced to either sell their LP stake or commit additional dollars to the new SPV if they wish to hold onto their stake. The GP has an extended investment term, potentially fresh capital to commit to new deals, and the chance of earning additional carry and fees. And the secondary buyer is able to put a good deal of capital to work in a concentrated portfolio with potential near-term liquidity. Some secondary buyers are clearly being forced to shift into unchartered waters.

As we at TIFF have watched the evolution of the secondary market over the years, and participated in it at times of our choosing, we have learned that a careful, consistent philosophy and approach are essential. Our philosophy is straightforward: 1) only buy what you know and when you have an edge, 2) understand that there are times to be a buyer and times to be a seller, and 3) focus on buying assets below long-term intrinsic value. This final point is critical. Investors can look at pricing in multiple ways in the secondary market, but the most popular is discount or premium to net asset value, or the current market value of a fund. Recent market pricing, however, has been affected by the large increase in public equity prices (potentially to frothy valuation levels) over the past few years. Private equity portfolio company NAVs tend to be based, in large part, on valuation multiples of comparable public companies. As a result, when the stock market rises, private equity NAVs will tend to rise in step. Because of this phenomenon, we believe secondary buyers today are evaluating portfolios that have already seen large increases in valuations over a relatively short period of time and, therefore, are more likely to be buying assets above their long-term intrinsic value. Determining intrinsic value involves detailed, company-level analysis and valuation work. We believe this is a sound practice, and we at TIFF tend to focus our own valuation work on discount to long-term intrinsic value, aiming to buy a fund at a price well below the expected future exit value of its underlying assets.

Any reader might reasonably wonder why TIFF, given this seemingly skeptical view of the current market, is still trying to acquire LP secondary interests. Indeed, as we pursued this effort during 2013, we saw several sellers come close to closing transactions with us, only to back out as they saw dollar signs from the stock market boom and from strong, consistent exits in the portfolio. The result of TIFF’s work evaluating scores of potential deals in 2013 was a single secondary transaction. The short answer to the question above is that we are trying to invest on our terms, not the terms driving the averages of the current market. As always, we are in no rush to make commitments unless our return target of 700 basis points over a global equity benchmark (the MSCI World Index) is achievable.

Seeking special secondary opportunities in markets like today's does take patience and specialized research and sourcing capabilities. We have not and will not chase deals. We do not care about discounts to current NAV, we do not count on portfolio company valuations keeping pace with steep public equity valuations, and we do not count on the IPO window remaining wide open or on M&A picking up further. With intermediated deal flow generally declining in quality, we have focused our efforts on unearthing proprietary deals from our networks of LPs, GPs, and other contacts and on continually working to improve our due diligence. The search for an attractively priced secondary that we eventually acquired in 2013 took nearly one year before we managed to source a proprietary transaction from a seller. While finding and closing such transactions is challenging, we have been close to closing on a number of meaningfully sized deals and believe one or two more will eventually hit.

Beyond our careful and disciplined work on secondaries, we have been active in co-investments and other opportunistic investments. TIFF has always viewed secondaries as cyclical, with the most opportunities arriving when the financial markets are volatile, in a downturn, or in turmoil. We've also believed that the flexibility to invest in other attractive, higher-return "special opportunities" was valuable to our members. Although we remain highly selective about these special opportunities and focused on completing additional secondary transactions, we expect to complete more opportunistic investments during 2014.

As we've already noted, TIFF also is active in the secondary market as a seller of private equity and realty funds. When the gap between our typical bids for secondary interests and the winning bids for the same grows to a surprising level, we take note that the market opportunity might be shifting to favor sellers. When we make the original commitment to a private equity manager, we are in for the long haul. But in the latter stages of a fund's life (typically years 10-15, for investors in a private equity fund), the benefit to participants often wanes. If a more attractive opportunity presents itself to investors, and separation from the old comes at a reasonably low cost, we would be derelict in our duty to not evaluate the trade-off. As we have explained in the preceding paragraphs, aggressive secondary buyers willing to pay full prices are now providing us with such an opportunity.

We've been in a similar situation before. In 2006, we felt that some of our managers' fund valuations had begun to exceed their intrinsic values, so we went to the market as sellers and found buyers willing to pay significant premia to the reported net asset values of our holdings. The market had clearly shifted to favor sellers over buyers. Further challenging buyers is the fact that, even with a high-quality portfolio, it's hard for a buyer to earn a return when they start with an inflated entry price.

Today, we have not reached the point of believing that our managers' valuations have exceeded the intrinsic value of their assets. However, as we have already discussed, market dynamics have pushed secondary buyers to accept higher entry prices, and therefore, lower returns. And so again we have entered the gray zone of whether it pays more to be a buyer or a seller. Though not nearly as obvious as it was to us in 2006, we do believe there are opportunities to exit certain mature investments that will enable us to take good money off the table and help us accelerate the wind-up of older TIFF portfolios. At the end of 2013 and beginning of 2014, we sold a handful of tail-end partnerships in some of TIFF's older fund of funds. Given the market dynamics previously discussed, our desire to return capital to our members, and the robust pricing of tail-end funds in the secondary market, we explored selling a large number of our partnership interests in underlying managers' funds, typically managers with whom TIFF no longer invests new capital. After evaluating a number of bids, we sold the funds that we believed had either peaked in value or did not offer attractive risk-adjusted returns to our members going forward. We were able to sell the funds at prices that were far more attractive to us than they would have been just a few months ago. Until the market corrects, we will remain open to potential sales if it makes sense for our members.

And eventually, we believe, the market will correct. Well-capitalized, mega-secondary funds will pounce on what they view as more reasonably priced secondaries, but, with record amounts of dry powder unlikely to decline for multiple years, they still will need to compete with one another to win transactions. That should prevent discounts from exploding at the large end of the market.

At the small end of the market, where we at TIFF have always focused, competition tends to be less stable and competing buyers are not always as knowledgeable. Thus, if financial markets face any turmoil, we expect to see attractive deal dynamics return — though perhaps not to the same levels as we have seen in the past. Despite secondaries entering the mainstream, we believe that inefficiency at TIFF's end of the market still exists. The proof lies in part in the wide bid spread we are seeing between high and low bidders in auctions (20% on average in the first half of 2013 across the market). More evidence emerges from the large number of proprietary deals and broken auctions, where no buyer enters a market-clearing bid.

We have always believed that a big part of our work as investors is to find market anomalies and exploit them. That is what we will continue to do on behalf of TIFF's member organizations. ■