White Paper

The Effect of Private Capital Liquidations

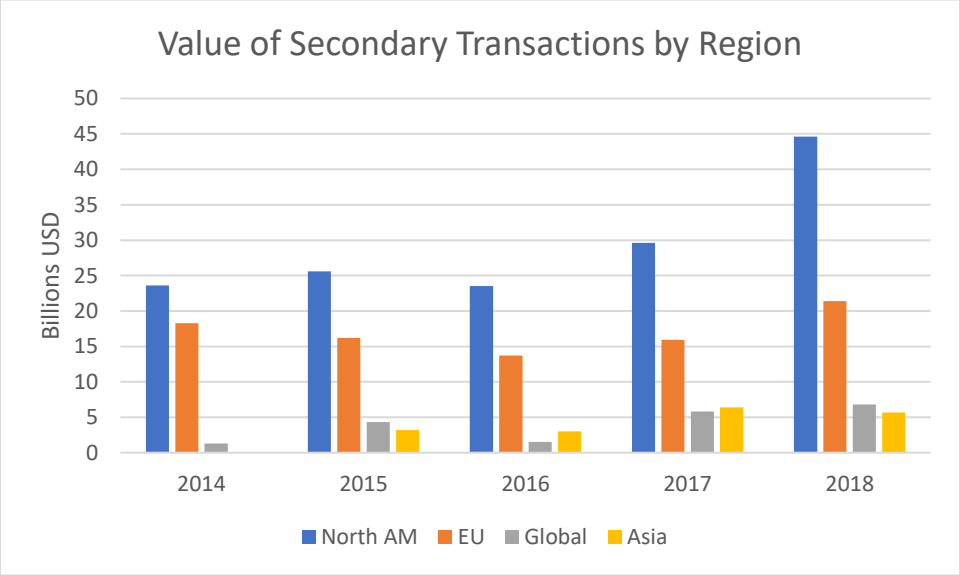
Transactions in the Growing Secondary Market

Dr. Jimmie Lenz, Principal, FRG

FRG

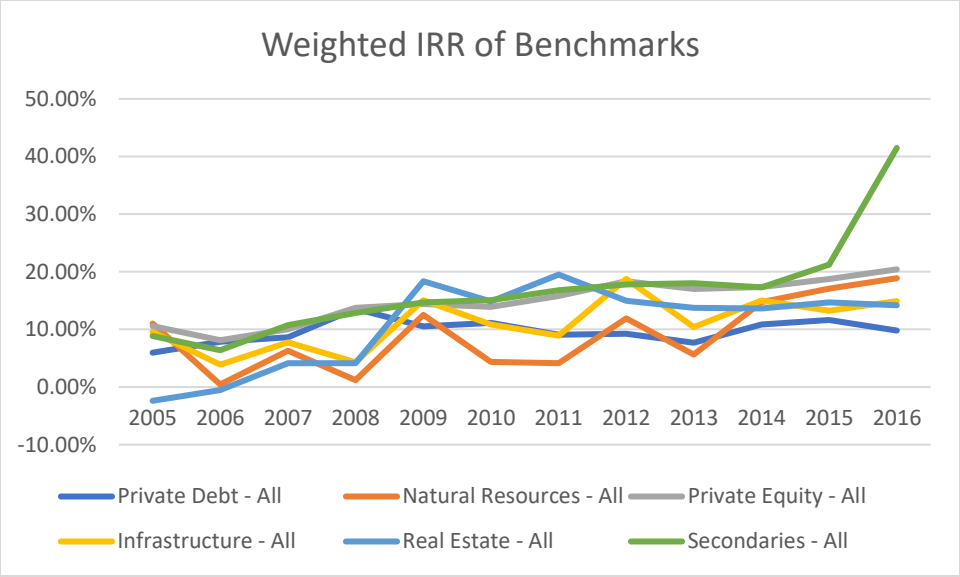
The demand for private capital investments continues to increase as investors of all types seek significant exposure to this asset type. However, this desire to expand allocations does not occur without some challenges. Investments in Private Equity and Private Debt have traditionally been characterized by a number of factors, primarily the inherent illiquidity of this type of investment, and the significant investment period. Each of these factors are changing and are discussed later. While these investments are transparent about the holding period, investors may find they need to liquidate private equity and private debt fund investments, prior to fund maturity, for a variety of reasons. The process of selecting the optimal fund, or funds, to liquidate is often challenging due to the lack of an accurate forecast of cash flows that the portfolio will generate. The value of calculating probable portfolio cash flows to assist in making sound business decisions is the purpose of this article. Additionally, this insight may provide some guidance in the use of the "secondary" market to facilitate investments more fully and maximize investment fund allocations.

The secondary market for private capital investments has grown significantly over the past few years in terms of participants, number and size of transactions, and the asset types transacted. Transactions in this space can be facilitated directly with other individual investors, or much more commonly via secondary funds that are active in the space. The number of transactions, as well as parties active in the secondary market, has grown by about 30% in the past 4 years, from 1,127 to 1,595, as detailed in the Setter Capital Annual Reports. In terms of capital transacted, the 2018 reported volume was $79.7 billion, an increase in over 31% from the prior year. Secondary funds continue to account for a significant portion of the buying at over 84% of last year's total, a trend that has been consistent in the secondary market, with new and existing funds expanding to accommodate the increased demand. Most buyers continue to be from North America, with European funds making up a significant portion. The chart below is based on information provided by the Setter Capital Annual Report, illustrating the growth and distribution of secondary transactions.



Data provided by Setter Capital

There is little doubt why secondary fund buyers have displayed a growing interest in the private equity and private debt market. The returns for this sector of private capital investments has consistently been a top performing sector, among all segments of this asset type. As shown in the chart below, utilizing returns weighted by fund size, the performance of secondaries has proved to be consistently better throughout different economic cycles.

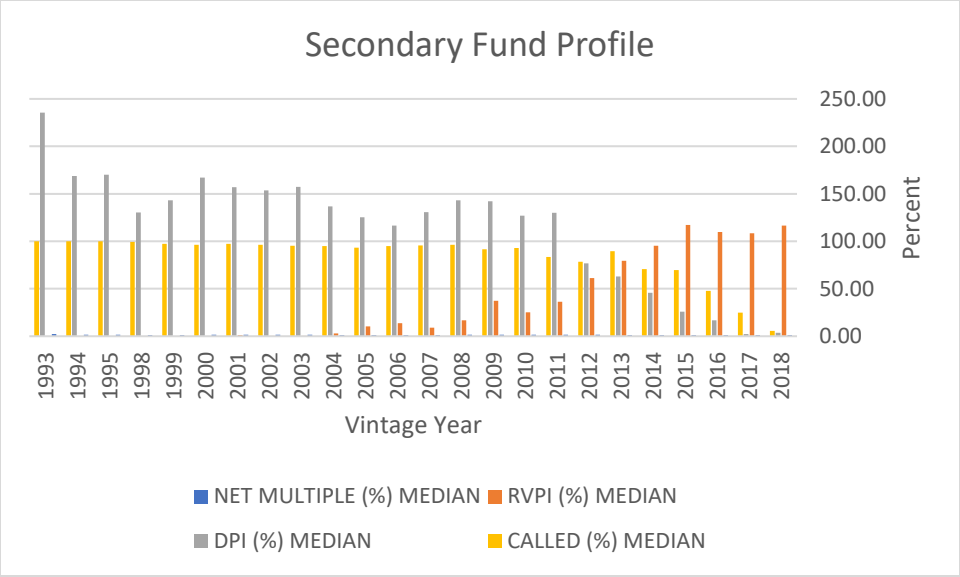


Data provided by Preqin

When assessing the above it is important to remember that secondaries contain a number of different asset types, roughly reflecting the weightings of the environment. Given this, one would intuitively expect secondaries to exhibit performance that reflects that of a broad "index" of the various fund types. However, as the chart displays, this is not the case. This significant variance in expected performance, secondaries versus the broad private capital environment, implies that investors would benefit from optimizing portfolios for the ideal funds to sell. Due to the growth of the secondary market, returns that may have been attributed to the "cost" of illiquidity, in particular for the more popular fund types, would seem to be significantly decreased.

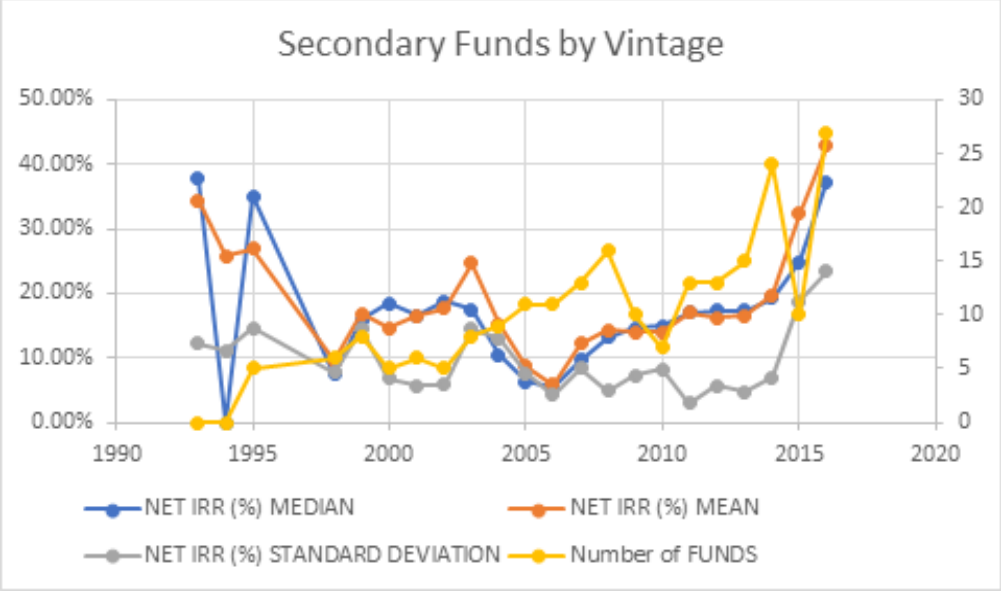
The need to liquidate long term investments, such as those in private capital investments, is often an unplanned event. This may be due to circumstances that were not foreseeable when the investment was undertaken, e.g. a change in the expected rate of retirements incurred by a pension fund (pension funds accounted for over 29% of the secondary sellers in 2018[1]). There are also cases in which the investment may not have performed as expected, often as a result of inaccurate capital calls and/or capital distribution forecasts. These misguided expectations may be with regard to the timing and/or the magnitude of the cash flows, both factors that are addressed in the PCF model. The Private Cash Flow (PCF) modeling technique pioneered by FRG provides investors with a superior methodology with which to forecast probable cash flows. Sellers informed of these probable cash flows could use this in the selection process, resulting in the retaining of alpha currently being realized by the secondary buyers.

[1] Setter Capital Volume Report 2018



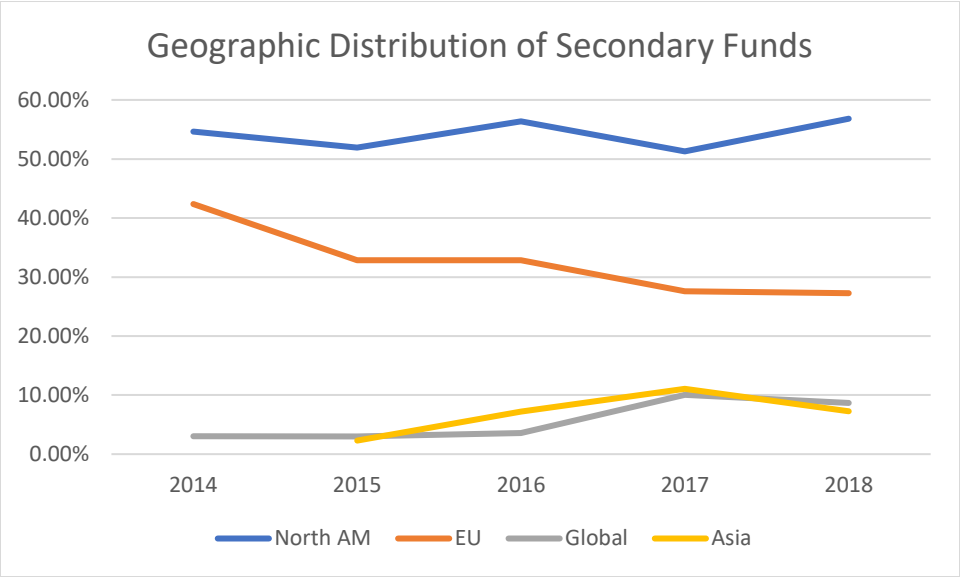
Data provided by Preqin

Correctly understood, portfolio cash flow probabilities can provide guidance on the optimal funds for liquidations, among other uses. To illustrate the opportunity cost of misguided fund liquidations an analysis was performed on secondary market performance, using a benchmark that was based on the weighted annual performance of different types of funds. The purpose of creating a benchmark is to control for the market performance of different sector funds. By controlling for the natural market performance in this way, a view of the lost opportunity cost via misguided secondary sales will be observed.



Data provided by Preqin

Fund sales in the secondary market were reviewed along several parameters to measure excess performance of the funds sold and realized by the secondary buyers. In constructing this analysis an effort was made to replicate the actual composition of funds transacted annually. This allowed for both the fund type and sub-type as well as the geographic distribution to be applied in a weighted "benchmark" to better approximate actual performance differences. The geographic distribution of the funds transacted in the secondary market from year to year is quite different, and was also accounted for to better characterize the actual returns. For example, from 2014-2018, distributions relative to North America, Europe, Asia-Pacific, and Global were observed as significantly different, allowing for performance to be better accounted for as illustrated in the chart below.

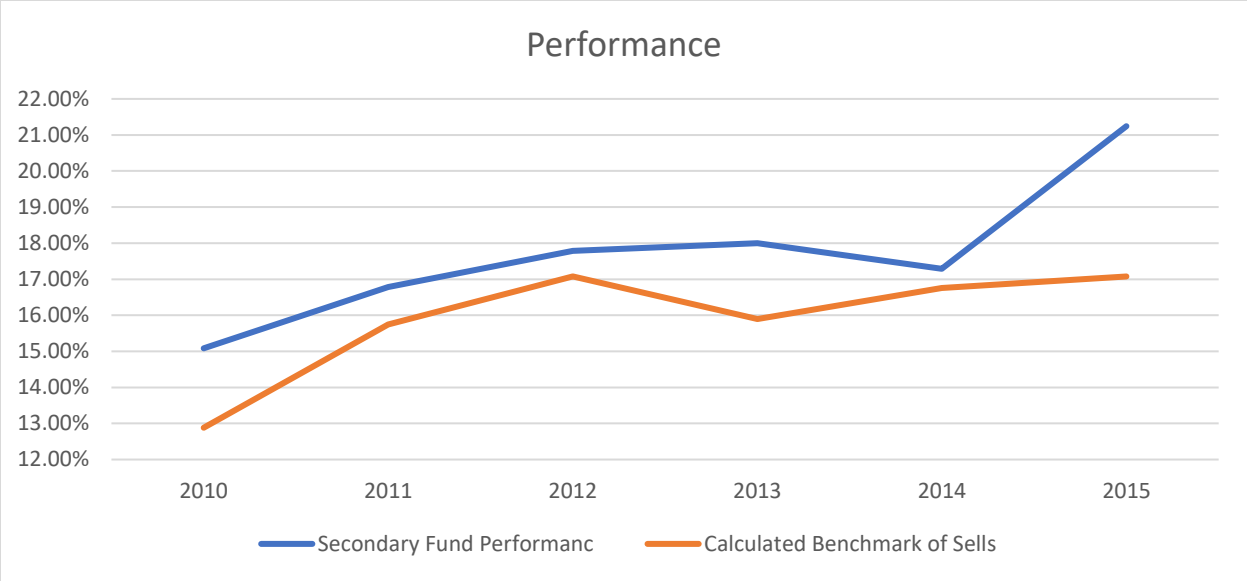


Data provided by Preqin

The individual constituent portfolio weightings were calculated on an annual basis, based on the detailed distribution findings of Setter Capital Volume Reports.[2] The distribution of fund types and geographies transacted in the secondary market was utilized to create a volume weighted benchmark by vintage and performance year. These benchmarks could then be utilized to find (on average) performance that may have been retained by fund sellers if portfolios had been optimized using PCF modeling techniques to identify the optimal funds to be sold.

As might be expected the differences varied over different periods, related to the vintage of the funds and the performance year. To better understand these elements the chart below reflects the cumulative performance of the calculated benchmark of funds transacted in the secondary market and the corresponding secondary fund performance.

[2] Setter Capital Report was used from 2014 to present. Prior to 2014 this was not available; a proxy based on the average of all years was applied to prior vintages.

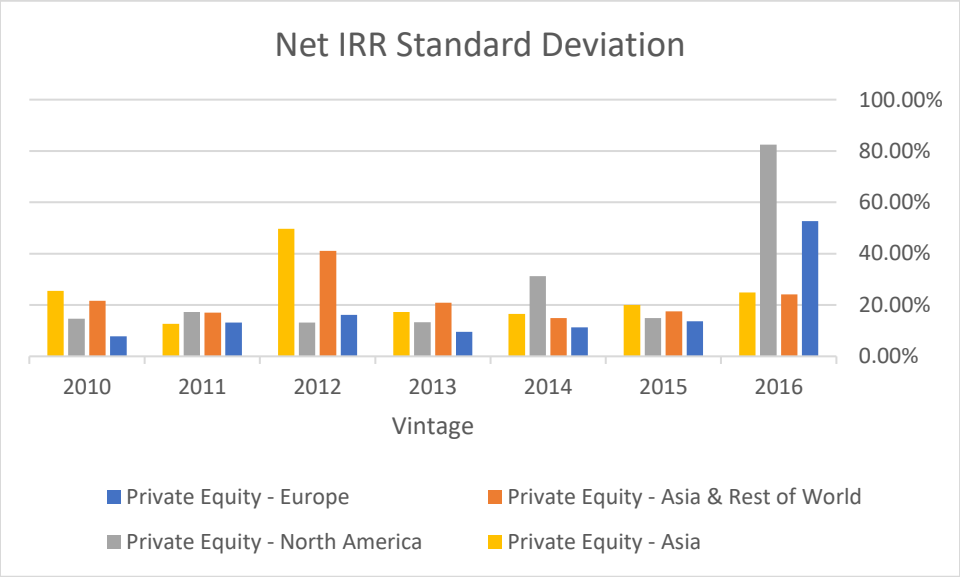


Data provided by Preqin

Over the time period illustrated in this chart the secondary funds outperform the benchmark by 9.9% annually. These results are similar, but a bit greater than results achieved in the paper "The Liquidity Cost of Private Equity Investments,"[3] likely due to different time periods examined. The paper found about a 5% difference during the period from 2006-2014, which closely approximates the early stage of this analysis. The 2016 vintage was excluded to provide better perspective on the longer-term performance difference. When the 2016 vintage is included, to date this has a realized difference of 56.7% and the average outperformance of secondaries rises to 16.6% annually over the entire 2010-2016 vintage universe.

It should be noted that the results are based on volume weighted averages, and this does not account for the significant standard deviations that may occur. However, the significant standard deviations illustrate the distribution of opportunities for sellers in the selection of funds to be liquidated in the secondary market.

[3] T.D. Nadauld, B.A. Sensoy and K. Vorkink et al., The liquidity cost of private equity investments: Evidence from secondary market transactions, Journal of Financial Economics, https://doi.org/10.1016/j.jfineco.2018.11.007



Data provided by Preqin

The chart here illustrates the most popular type of private capital investment, private equity throughout various geographic regions and the standard deviation for the fund vintages listed through the current reporting period.

There is no question that this asset class will continue to expand, and that some investors will be faced with the need to liquidate their private capital fund investments prior to maturity. By utilizing the PCF modeling solutions to assist investors in optimizing the fund (or funds) selection process, returns captured can significantly enhance portfolios. As illustrated here, and documented in other research, the secondary market returns deltas provide illustrations of the returns that can be lost if investors are not fully informed. As the secondary market continues to grow, and provide liquidity, previous assertions concerning the "cost" of liquidity risk have become less of a factor. This provides an excellent opportunity for investors to use tools more common to the public markets to better optimize portfolios.

Future articles and white papers will focus on additional changes in the private capital space, e.g. long dated funds, capital call financing, etc. FRG continues to focus on identifying changes in the private capital environment that may affect forecasting capabilities.

FRG would welcome the opportunity to speak with you concerning the findings of this paper, as well as how the approaches developed may fit into specific environments. For more information contact us at info@frgrisk.com or 919.439.3819.

Visit us online at www.frgrisk.com.

VISIT US ONLINE AT WWW.FRGRISK.COM

FRG

264 W CHATHAM ST CARY NC 27511 P + 1 (919) 439-3819

www.frgrisk.com | info@frgrisk.com