The PE Secondaries Market Continues to Evolve Rapidly

Navigating an Increasingly Complex Ecosystem

At the beginning, things were straightforward. Secondary investors generally sought diversified exposure to private companies by purchasing LP fund positions or portfolios of LP fund positions, often at a discount to reported net asset value. Secondary investors were attracted by returns that might result from the discounted purchase price at entry as well as future appreciation in the value of the underlying portfolio companies. By purchasing a secondary interest and entering a private equity fund later in its lifecycle, investors hoped for a shorter time to liquidity (potentially resulting in an attractive IRR) at the expense of potentially lower return multiples. In general, investors seeking secondary exposure for their portfolios sought to deploy capital fast and capture liquidity, while also getting diversified exposure to private assets across vintages, strategies, and industries.

Until a few years ago, secondary strategies were relatively similar in terms of economic exposure and the market was quite homogeneous. Differences in the overall returns of various secondary portfolios were often driven by differentiated deal flow or proprietary due diligence and underwriting processes and generally not by fundamentally different investment strategies and economic risk-return profiles. Leverage was relatively rare; GP-led and single asset transactions were not yet on the agenda; and most secondary purchasers focused on buyout exposure. Overall, secondary portfolios operated with broadly comparable investment strategies and risk-return expectations.

Today's Complex Secondaries Ecosystem

Fast forward to today, the secondaries market has developed into an increasingly complex ecosystem with different investment strategies focused on fundamentally different economic exposures. For example, some large secondary funds seek highly diversified exposure to the broader PE market while other secondary funds take on more asset concentration. There are secondary investors specializing in venture capital or infrastructure and some focus exclusively on real estate. Certain secondary players focus on tail-end fund solutions whereas others seek to invest in more recent vintages. In addition, preferred equity funds take on more senior positions in the capital structure and target a lower risk-return profile, similar to mezzanine capital. When overlaying all this with different approaches to leverage ranging from simple capital call subscription lines to significant portfolio or deal level leverage, it becomes increasingly difficult for investors to evaluate the potential for returns and risks of a secondary portfolio. Questions that many secondary investors are faced with today include:

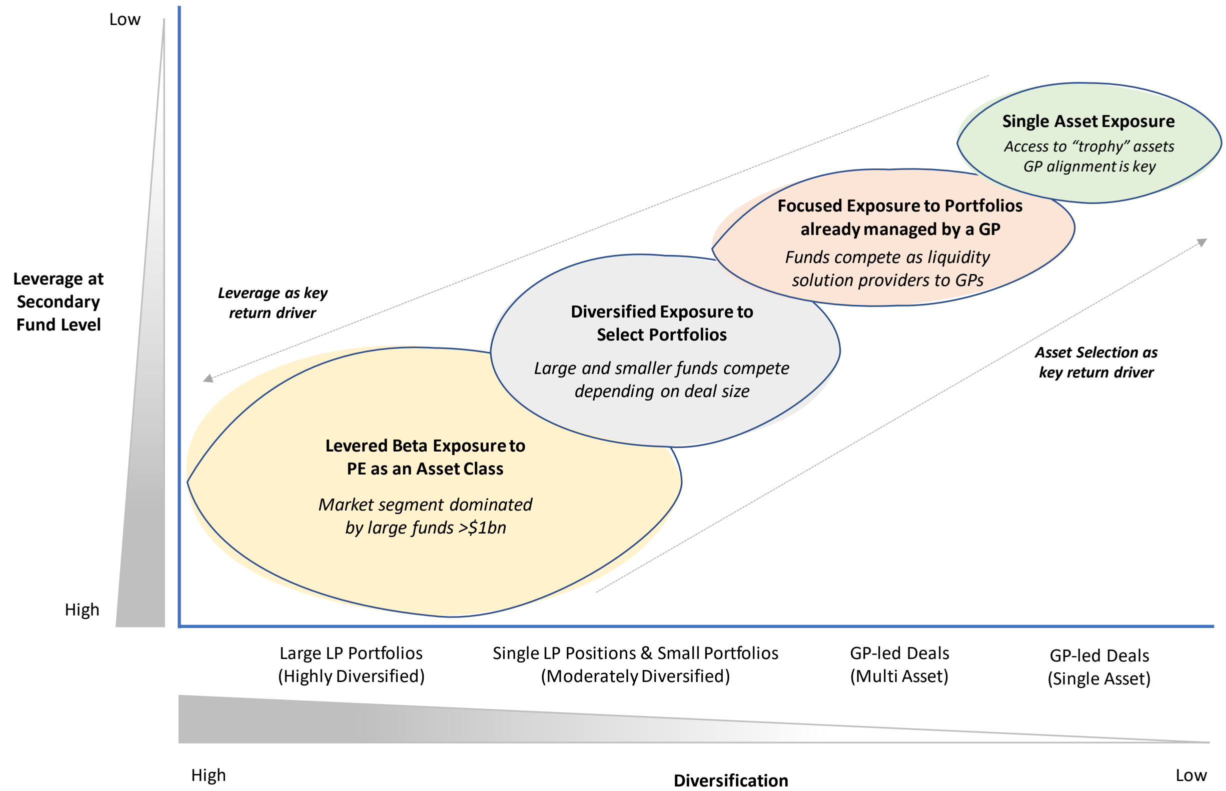
- *How much added leverage am I exposed to at the deal level and at the fund level?*
- *How diversified is the exposure to underlying companies? Will I be under- or overdiversified?*
- *How much of the return will be driven by discounts vs. future value appreciation of the assets?*
- *How much unfunded capital will I be exposed to? Is it accretive or dilutive to returns?*
- *What will the cash flow profile look like? Will capital deployment be delayed due to credit lines and deal level leverage? How much capital will be put to work by the fund?*
- *What types of strategies will I be exposed to? Buyout vs. venture vs. growth equity?*

The list only captures the tip of the iceberg and emphasizes that not all secondary investment strategies are created equal (anymore). To navigate today's complex secondary market, investors need to answer a single but key question: *What risk-return profile and secondary investment strategies are appropriate for my portfolio?*

Overview of Secondary Transactions and Investment Strategies

To answer this question, it is important to look at the different types of underlying secondary transactions and investment strategies. Generally, transactions range from (i) highly diversified portfolio deals that can be levered to (ii) very concentrated single asset deals. In highly diversified portfolio deals, idiosyncratic risk is low and higher returns are achieved through additional leverage. These types of transactions essentially provide levered beta exposure to PE as an asset class. On the other end of the spectrum are single asset transactions with higher idiosyncratic risk. Asset selection is a key return driver for these concentrated deals and additional leverage is typically not available or necessary to drive returns. The importance of asset-level diligence increases across the spectrum for increasing levels of asset concentration.

Overview of Secondary Transactions



Adhering to an appropriate investment strategy and risk-return profile may also be complicated by the fact that secondary managers often seek to invest across the different transaction types, building portfolios that include (i) large and highly diversified LP portfolios, (ii) more concentrated transactions, as well as (iii) exposure to single asset deals. To properly assess a secondary investment strategy, investors must determine if anticipated returns are expected to be driven primarily by leverage or by asset selection.

Navigating Today's Ecosystem

With so many different strategies and sub-strategies in the secondary market available today, it can be a daunting task to evaluate the market. During recent years, the market appears to have bifurcated into two broad segments:

- ***Large and mega secondary portfolios providing highly diversified exposure:*** Although secondary funds invest across the spectrum of transaction types, larger secondary funds generally provide more diversified exposure given that these larger vehicles often invest a significant portion of their capital in big, multi-fund portfolios to deploy capital efficiently. These transaction types allow for deployment of capital quickly in a highly diversified manner with the ability to back-fill past vintages through exposure to tail-end portfolios. Exposure to these large and diversified portfolios can for example be useful when building up an investment program from scratch. The strategy at times provides initially high IRRs that can burn off as discounts are realized. The potential to generate high return multiples is however often limited given the high level of diversification and mature nature of the underlying investments. Secondary strategies that provide this exposure are typically more focused on IRR and less focused on return multiples.

- ***Smaller secondary portfolios providing more focused exposure***: Secondary investors with less capital to deploy may not be well positioned to take down large portfolios and instead may focus on more concentrated deals including single fund interests and other more focused portfolios. Exposure to these types of portfolios can be a useful addition for institutional investment programs that are looking for strong return multiples and that can support a slightly higher idiosyncratic risk profile. Returns for these portfolios are often driven by capturing inefficiencies at the smaller end of the market or by exposure to a successful individual deal or asset. Focusing on single LP positions or more concentrated portfolios allows this strategy to identify underlying portfolio companies that can drive multiples of invested capital. Secondary strategies that provide this exposure are typically more focused on return multiples and less focused on IRR.

Differences in Return Profiles

Since transaction-level performance information across the secondary market is not readily available, our analysis of differences in return profiles between highly diversified strategies vs. more focused portfolios relies on fund size as a proxy for the two investment strategies. While not a perfect proxy, the larger funds tend to provide relatively more diversified exposure whereas the smaller funds tend to pursue strategies that are relatively more focused.

Figure 1: Secondary Funds Performance by Size and Vintage Year

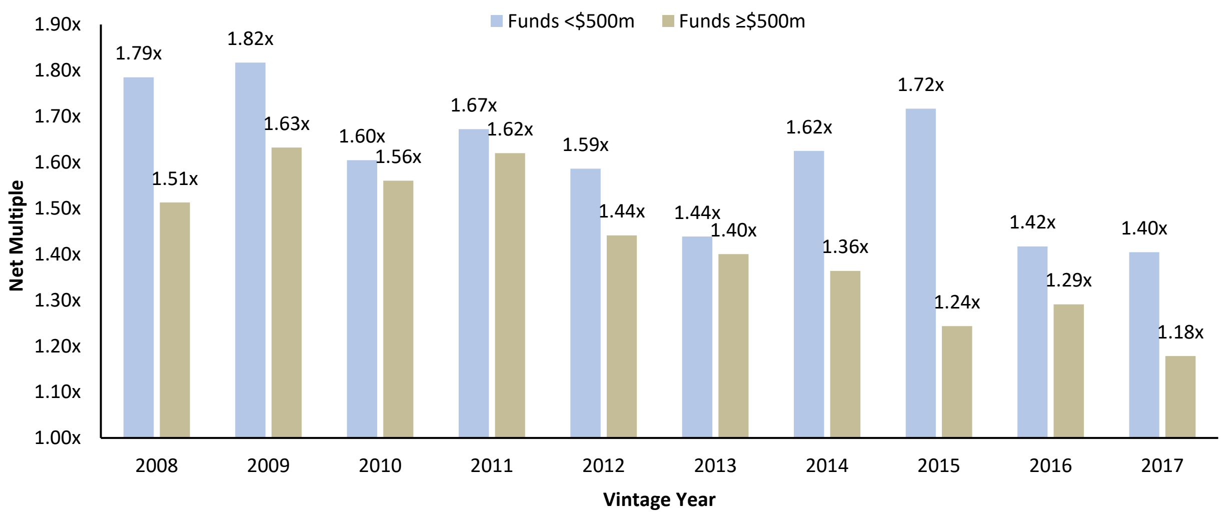


Figure 1 Data Source: Preqin. Data sourced 10/31/2020.

A review of Preqin data of secondary fund performance for vintages between 2008-2017 (ten years of mature fund data) indicates that secondary funds smaller than $500m have offered a different return profile when compared to larger funds that are $500m or greater in size.[1] The data shows that the smaller funds historically achieved higher net multiples than the larger funds, potentially driven by a more focused exposure at the smaller end of the market. However, when comparing net IRRs, the data shows a more mixed picture with the larger funds providing higher net IRRs in four of the ten years despite the generally lower net multiples. Larger funds typically invest in large, diversified deals that are often relatively mature. Buying these mature portfolios at a discount and applying leverage might explain the relatively higher IRRs.

[1] Data Source: Preqin. Data sourced on 10/31/2020; returns are as of 9/30/2020, or last reported date, if earlier. Includes 168 secondary and secondary direct funds with vintages between 2008 and 2017 (106 funds less than $500m in fund size and 62 funds with a fund size equal to or greater than $500m). **Past performance is not indicative of expected future returns and returns will vary in the future.**

Figure 2: Secondary Funds Performance by Size and Vintage Year

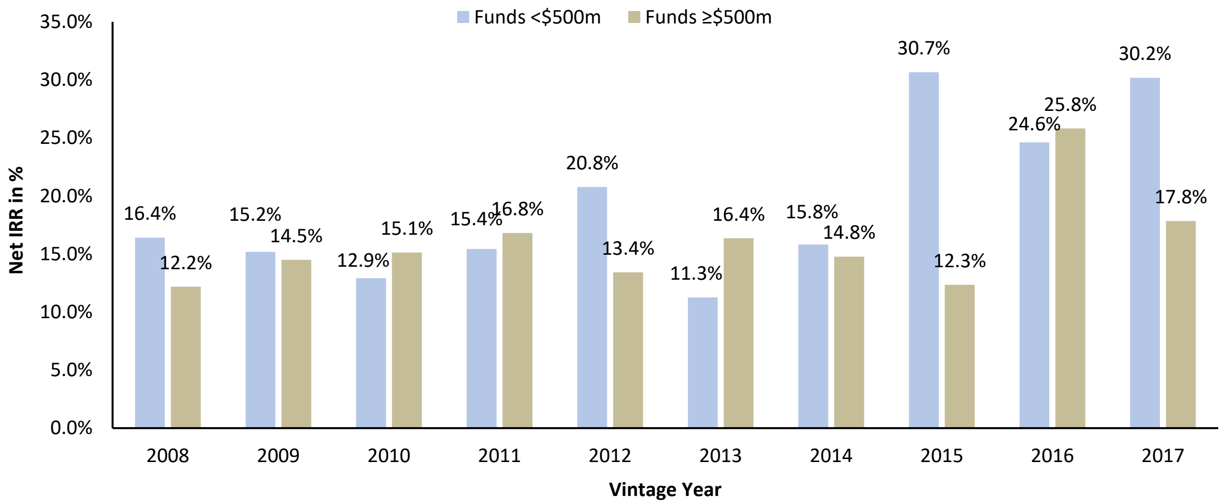


Figure 2 Data Source: Preqin. Data sourced 10/31/2020.

In summary, the smaller funds may have been more focused on generating higher net multiples through asset selection whereas the larger funds appear to have been more focused on generating higher IRRs, likely by investing in highly diversified mature portfolios and adding leverage as a return driver.

Interestingly, the equal weighted (not capital weighted) average net multiple and net IRR of the smaller funds outperformed the larger funds by 0.17x net multiple and 280bps net IRR across the 2008-17 vintages.

Figure 3: Secondary Funds Performance by Size Average 2008-2017

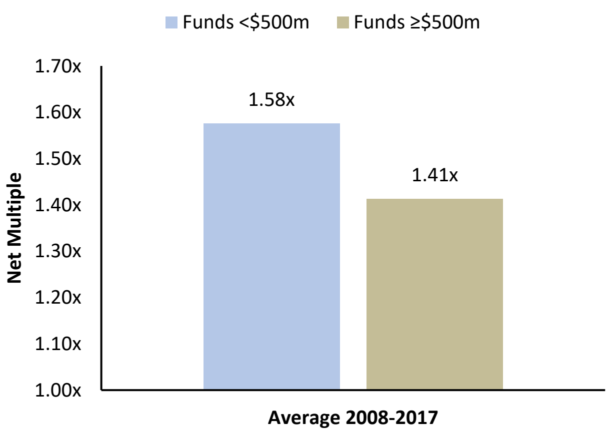


Figure 3 Data Source: Preqin. Data sourced 10/31/2020.

Figure 4: Secondary Funds Performance by Size Average 2008-2017

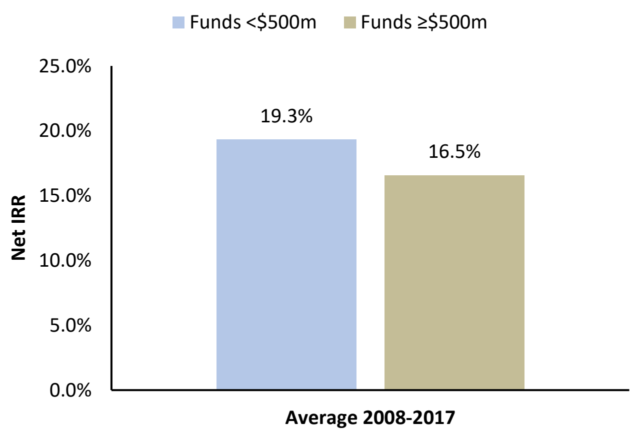


Figure 4 Data Source: Preqin. Data sourced 10/31/2020.

But What About Risk?

Different return profiles are of course just one side of the story. When comparing the risk profiles of the two investment strategies, the data indicates that the more focused exposure of the smaller funds, and correspondingly higher historical returns, might come at the expense of a slightly elevated risk profile. Measured as the dispersion of net return outcomes, the smaller funds show a wider interquartile range (from top to third quartile) from 1.74x at the upper end of the range to 1.33x at the lower end of the range compared to 1.56x to 1.27x for the larger funds.

A comparison of the min-max ranges also indicates that the smaller funds had a slightly higher dispersion of net returns compared to the larger funds.[2] The dispersion of net IRRs provides a similar picture with a more banded return profile for the larger secondary funds compared to the smaller funds.

Figure 5: Secondary Funds Return Dispersion by Fund Size
Net Multiple

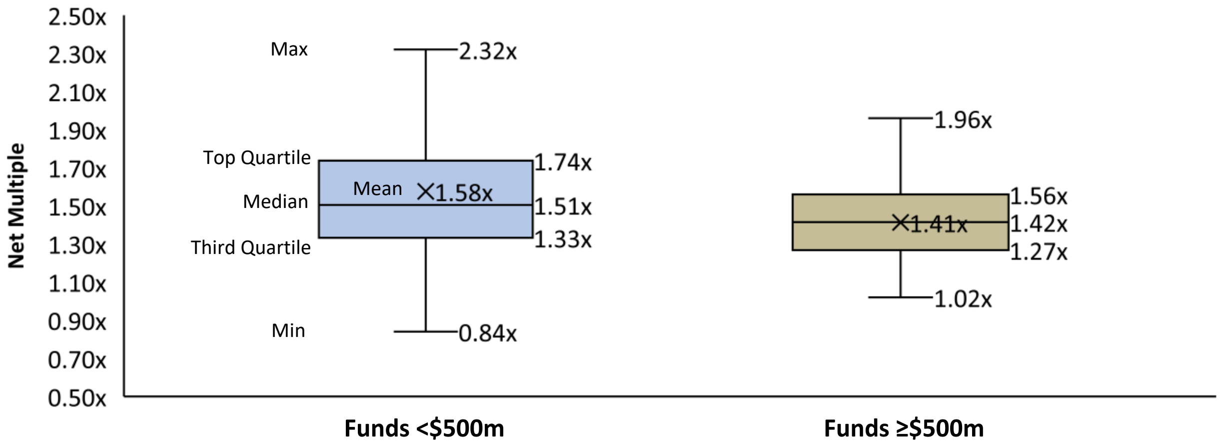


Figure 5 Data Source: Preqin. Data sourced 10/31/2020.

Figure 6: Secondary Funds Return Dispersion by Fund Size
Net IRR

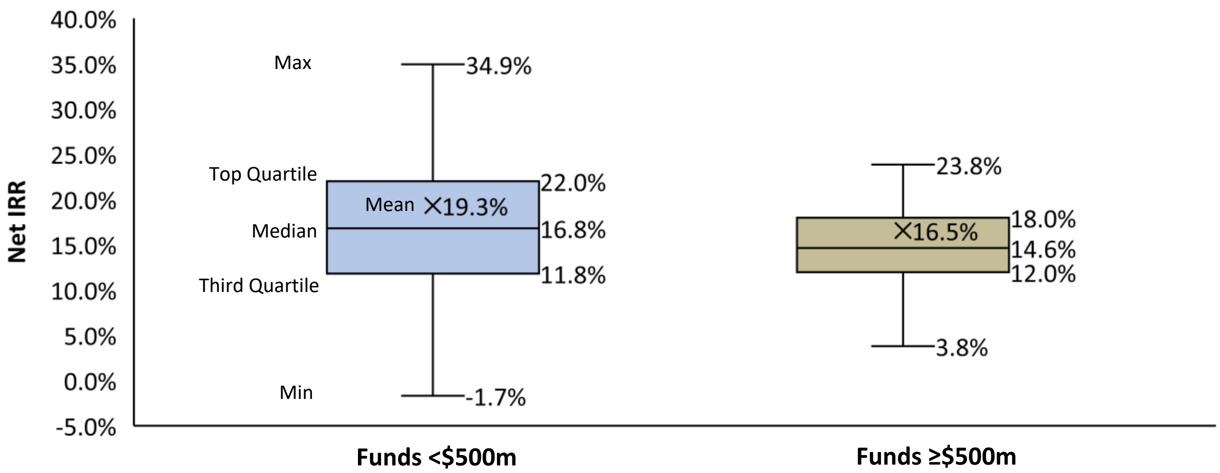


Figure 6 Data Source: Preqin. Data sourced 10/31/2020.

Historically, investors in more focused secondary strategies (represented by the smaller funds) appear to have been compensated for the slightly increased risk as indicated by the higher average (mean) performance of 1.58x / 19.3% nIRR compared to 1.41x / 16.5% nIRR for highly diversified strategies (represented by the larger funds).

For investors that are looking for secondary investments predominantly as a tool to boost IRRs and are willing to accept potentially lower net return multiples, investments in large, diversified portfolios may provide an attractive

[2] The min-max range is calculated using MS Excel's standard box and whisker chart tool, which excludes outliers defined as values 1.5x the interquartile range below the lower quartile and above the top quartile.

way to achieve this goal while keeping a slightly lower risk profile. Investors that are looking to generate higher net return multiples and that can tolerate slightly elevated risk as measured by the dispersion of potential outcomes may find attractive opportunities with more focused secondary investment strategies.

Summary

The PE secondary market has become increasingly complex. Investors need to understand the economic exposure that a specific secondary strategy might provide since the different strategies no longer have comparable risk-return profiles. Secondary investors build portfolios with exposure to a variety of deals that range from large, diversified portfolios to concentrated single asset transactions. A portfolio's aggregate risk-return profile depends on its weighted exposure to the different transaction types. Often, large secondary portfolios seek to provide more highly diversified exposure whereas smaller secondary portfolios seek to provide more focused exposure.

At Abbott, we believe that a secondary strategy geared towards more focused exposure provides an attractive risk-return profile. Smaller transactions with clearly identifiable return drivers allow us to leverage our information and relationship advantages. A focused approach to secondaries can allow a secondary investor to prioritize deal flow and conduct in-depth and meaningful diligence on investment opportunities designed to generate potentially attractive returns.

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