ABBOTT CAPITAL

Perspectives in Partnership is Abbott's series that provides our audience insights into the information and knowledge we have accumulated during our four decades of investing in the private equity and venture capital markets and our unique position as both a general partner (GP) and limited partner (LP).

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SECONDARY SIGHTINGS: PART I

We begin this multi-part installment on private equity secondaries by sharing our perspective on the market and taking a deep dive into secondary investments – what they are, how they can generate returns for investors, their role in private equity portfolios, and what investors need to consider when assessing secondary performance.

What are the different types of secondary investments?

At the most basic level, secondaries transactions involve the purchase and sale of existing positions in private equity and venture capital funds or companies. There are various types of secondaries transactions and structures, but most often, they fall into one of three categories.

The "traditional" secondary market, as now often dubbed, is when a limited partner in a private equity or venture capital fund needs liquidity before the end of the fund's life. In that instance, the LP is looking for a potential buyer to purchase their interest in the fund, sometimes at a discount to NAV, in exchange for liquidity.

1. **FUND OR LP PURCHASE**
   Purchase of an existing LP interest in a private fund or portfolio of funds.
2. **GP-LED TRANSACTION**
   Single or multi-asset purchase as part of a fund restructuring, continuation vehicle, or tender offer.[1]
3. **DIRECT SECONDARY**
   Purchase of company shares directly from an existing investor, employee, or founder.

[1] Note: Other GP-led solutions, including NAV loans and preferred equity structures, are available. Those solutions, sometimes referred to as fund financings, are not the focus of this paper.

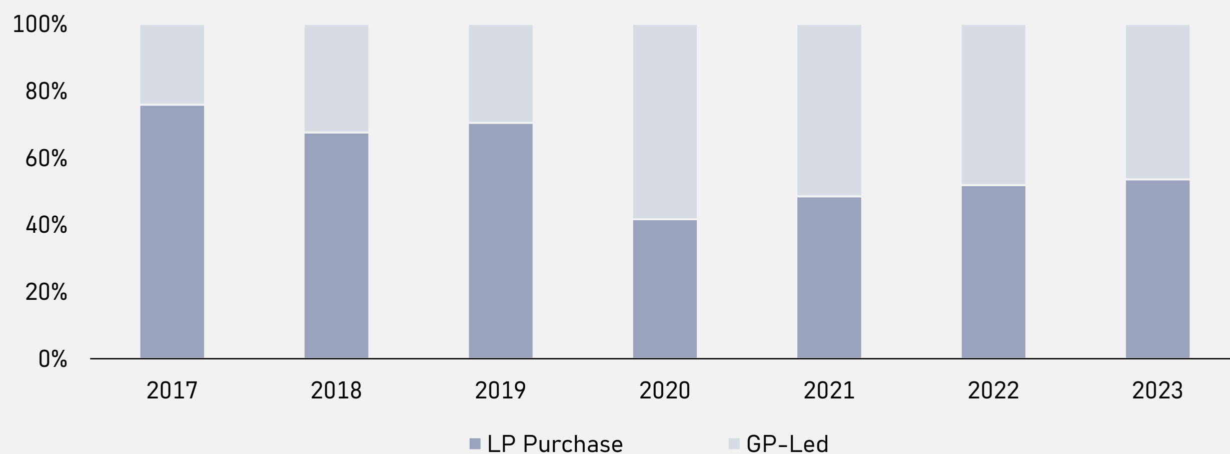
These transactions are frequently referred to as LP-led or LP purchases and, for the three years prior to 2020, accounted for roughly 70% of all secondary transaction volume each year. From 2021-2023, LP purchases have accounted for ~50% of the total market as GP-led transactions have become more popular (see Figure 1).

GP-led transactions can take many forms, but ultimately, they are transactions initiated by the GP (rather than the LP) aimed at offering liquidity to investors before the end of a fund's life. GP-led transactions may also be referred to as continuation vehicles (CVs) or continuation funds (CFs) and can be comprised of a single or multiple assets that the GP already manages. Essentially, a GP carves out an asset (or assets) in an existing fund and moves them to a special purpose vehicle (SPV). Existing LPs are given a chance to "sell" (take liquidity) or "roll" (re-invest their pro rata portion, including any gains) into the SPV. The SPV is typically structured as a new fund with a new term, a reset fee, and an incentive structure. Any LPs who choose to sell are replaced by secondary buyers (i.e., the investors capitalizing the transaction).

Direct secondaries are similar to fund or LP purchases, but rather than buying interests in a private equity or venture capital fund, the secondary buyer acquires shares of a private company directly from an existing investor, employee, or founder in the company.

Today, secondary investors may decide to invest exclusively in LP purchases, GP-led transactions, direct secondaries, or a combination thereof. Each transaction has a distinct risk/return and anticipated liquidity profile, which means that not all secondaries can generate returns similarly.

Figure 1: Annual Secondaries Transaction Volume
2017–2023



Data Source: Jefferies Global Secondary Market Review, January 2024

How can different types of secondaries generate returns?

This question gets at the heart of the evolution of the secondary market and it's important to remember that there are various ways to generate returns by investing in secondaries.

Fundamentally, there are three core components to evaluating secondaries performance: discount factor, asset growth, and multiple expansion. Each plays a distinct role depending on the transaction type and the secondary investor's strategy.

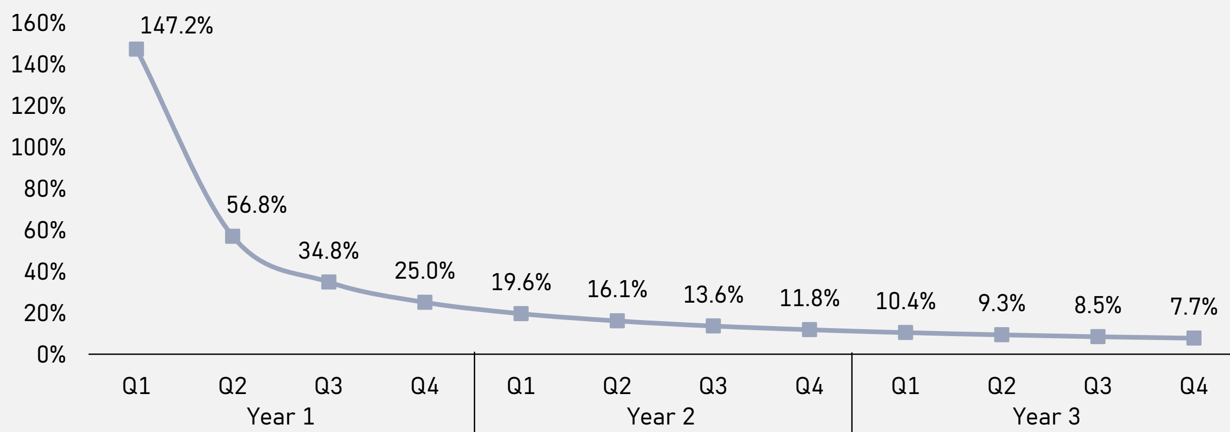
Discount Factor

This portion of secondaries return potential is most often associated with LP purchases (although some GP-led transactions have recently been priced at discounts, too). A discount, or reduced purchase price paid relative to reference date NAV, can drive a portion of secondary returns, particularly in the early years of the investment. Secondary investors focusing on discount transactions typically buy tail-end funds or portfolios and seek to make money "on the buy." These investors can often experience a short-term unrealized gain as the discount leads to a corresponding value uplift.

For example, buying an LP position for 80 cents on the dollar leads to an immediate uplift in value to 1.25x in the first quarter after closing (100/80) and a correspondingly high 147.2% first-quarter IRR. However, as time passes, without liquidity, the initial discount-driven "pop" in IRR will quickly evaporate. Figure 2 below shows how (all other things remaining equal and no interim liquidity) the initially high IRR drops to below 8% within just three years due to the exponential decay of the IRR over time.

Relying on a discount alone to generate meaningful returns may not be enough to meet most investors' underwriting targets without meaningful interim liquidity. Receiving full liquidity on a portfolio of discount-driven secondaries within a year to lock in a 20%+ IRR is unlikely, and even then, a 1.25x return alone (without asset or multiple growth) would probably not meet most investors' targets. This is where the other two critical components come into play.

Figure 2: Internal Rate of Return



For Illustrative Purposes Only

Asset Growth

While getting a discount is a "nice to have," underwriting revenue or EBITDA growth is typically a "must have" and can be a significant driver of value creation. This is true for secondary investments in the same way it is true for any equity investment. Understanding and underwriting asset growth potential in a secondary transaction can be time-consuming and is typically coupled with a concentrated approach. Secondary investors focused on asset growth would need to evaluate both the upside potential for the existing portfolio companies and the underlying GP's ability to drive top-line and margin improvement initiatives that will ultimately translate into higher revenue and EBITDA levels at exit. The *growth component* of returns can apply to both LP purchases and GP-led transactions. Generally, the more concentrated a portfolio is, the deeper and more focused a secondary investor's diligence will be at the asset level to evaluate specific asset growth components.

Multiple Expansion

Lastly, the exit price at which the underlying portfolio companies are sold is an important factor in generating equity returns. GPs aim to achieve multiple expansion by positioning an asset for a higher exit valuation multiple (expressed as EV/Revenue or EV/EBITDA) compared to the price at entry. As secondary investors evaluate a portfolio, they should assess where the companies are valued at the entry point (the secondary purchase reference date) and if there is further potential for multiple expansion.

An exit valuation multiple generally depends on several company-specific and external market factors, including, but not limited to, the quality and health of the underlying business and a favorable exit environment. Often, multiple expansion is a direct result of achieving operational efficiencies, improved margins, and higher levels of scale and diversification. We have found bigger, more efficient, and diversified companies can typically command a higher valuation multiple than a smaller, less efficient, and still very concentrated business.

As the market matures, some secondary strategies focus more on buying large and highly diversified tail-end positions. The discount factor plays an integral part in generating returns for these strategies. While asset growth and multiple expansion are also important, a detailed asset-level underwriting of growth and margin expansion is generally less central given the often very high level of diversification.

On the other end of the spectrum are secondary investors that buy more concentrated positions (including investors focused solely on single-asset GP-led deals). A more fundamental bottom-up approach to evaluating asset quality, future growth, and multiple expansion potential is critical for these strategies. Secondary investors in this category typically rely less on discounts to generate their returns and instead look for opportunities with strong value uplift potential over time.

Fundamentally, there are three core components to the performance of secondaries: **discount factor, asset growth, and multiple expansion.**

Where might LPs fit secondaries in their overall private equity allocations?

As the secondary market evolves and LP portfolios mature, participants must decide why and how a secondary allocation fits into their portfolio.

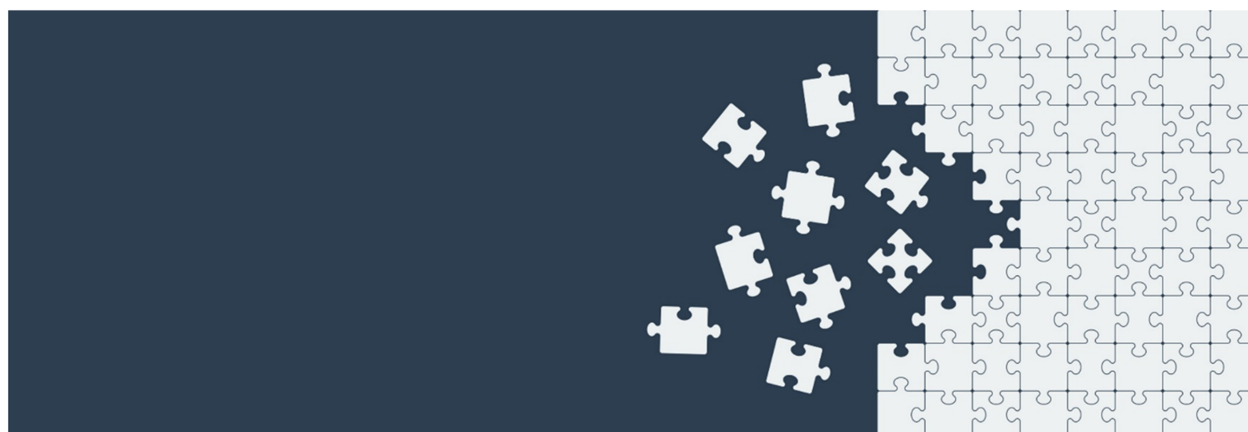
Secondary strategies are generally viewed as potential j-curve mitigants for two main reasons: (i) secondary transactions are often (close to) fully deployed at closing, and (ii) the return of capital typically comes earlier in the life of a secondary investment compared to a primary fund investment.

For LPs starting PE programs: a secondary allocation is often considered to help mitigate the j-curve and quickly bring overall PE exposure closer to target levels. In this instance, an allocation to a secondary strategy may be temporary, and the goal might be to target LP purchases as part of the secondary strategy. LP portfolio purchases can offer diversification by vintage year and strategy; purchasing underlying funds from older vintage years will also likely yield earlier distributions to recycle into new funds and strategies.

For LPs with more mature PE programs: a well-diversified secondary strategy with early cash flows may no longer be needed. Instead, LPs may prefer the reduction in blind-pool risk that secondary investments offer (compared to primary fund investments) and may seek to pursue slightly more concentrated strategies with a higher emphasis on asset growth and multiple expansion.

Depending on the role that secondaries play in an investor's portfolio, a dedicated secondary allocation may be carved out from the broader PE allocation similar to sub-allocations to buyouts, venture, and growth. An allocation to secondaries may also reside within an investor's special situations or tactical allocation.

While different investors have different needs and reasons to invest in secondaries, we believe LPs are increasingly adopting secondaries as a core component of a private equity allocation.



How are LPs assessing secondary performance given the rapid evolution of the asset class?

As the secondary market continues to mature, investors increasingly have the choice between different risk/return profiles, ranging from (i) very large and highly diversified strategies with lower risk/return profiles to (ii) more concentrated strategies with higher target returns but also higher potential risk.

In this context, choosing the right secondary strategy for a portfolio is not an easy task. Investors that deploy capital quickly in tail-end portfolios at discounts may show very high interim IRRs at the outset, but these IRRs can decrease over time. On the other hand, secondary strategies focused more on future value uplift (via asset growth and multiple expansion) may only show meaningful performance after a few years when value creation ultimately becomes visible in the reported return numbers.

Investors seeking to implement a secondary strategy need to answer two fundamental questions: (i) What risk/return and distribution profile am I looking for when adding secondary investments to my portfolio? and (ii) What type of secondary investments are best positioned to provide me with the desired exposure going forward? To answer these questions thoughtfully, we believe it is important to analyze both mature secondary performance and interim or largely unrealized results to understand the expected risk/return profile provided by each.

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