Dipping into private equity

Secondary funds allow the merely rich to access coveted asset class

›BY ARTHUR SALZER

ALTHOUGH CANADIANS HAVE experienced a buoyant stock market this past year, the longer-term outlook is for subpar returns compared to the past 30 years. These reduced return expectations do not reduce the demand for returns by pensions and endowments, nor for families who desire to maintain the purchasing power of their financial wealth after accounting for taxes and inflation, which creates a bit of a hole in their portfolios.

During the past decade, institutions such as the Canada Pension Plan Investment Board (CPPIB) and endowments like those run by Yale and Harvard universities have successfully invested in private equity, which has further diversified their portfolios and improved returns. But for many non-institutional investors (even families of extreme wealth), the 10-15-year life cycle of private-equity funds has proven to be too long. This is where secondary private-equity investing comes in.

Secondary private-equity investing is the buying and selling of existing stakes in private-equity funds from other fund investors. By nature, private equity is intended to be a long term-investment for buy-and-hold investors. Secondary funds take an interest in high-quality private-equity funds from investors seeking liquidity in a fair and timely manner.

> “Secondary private equity accounts for a transaction value exceeding $42 billion

The idea behind secondary transactions was often driven by an investor’s unanticipated need for liquidity. This was particularly relevant during the financial crisis in 2008. Fast forward nine years and there are more factors coming into play such as: new regulations for banks to reduce exposure to private equity, portfolio rebalancing and exiting aging investments that have little perceived upside. Today, the market has grown from its small beginnings, when secondary transactions typically accounted for 3% to 5% of all primary commitments, to more than 10% of commitments and a transaction value exceeding $42 billion.

Why so much interest in this relatively new area of investing? The benefits of secondary private-equity investing are many. Investors appreciate being able to deploy capital at a quicker rate over a period of a few years as opposed to traditional funds that call for commitments that last half a decade or more. As the investor is buying mature funds where a significant portion of capital is called, there is enhanced transparency since the buyer can examine what has been being bought as opposed to entering a blind pool. And while valuations are higher today than just after the financial crisis, there have been significant opportunities to buy funds at a discount to net asset value (NAV).

Combine these factors together, and investors in secondary private-equity funds tend to experience a shorter investment life cycle and avoid the drag of young immature investments, known as the “j-curve” effect. Executed correctly, the results have been very positive. The median secondary fund experiences historically higher internal rates of return vs. traditional private equity, as well as increased diversification within the private-equity asset class by investing across vintage years, industries, geographies, managers and strategies.

Investors considering placing money with a secondary private-equity manager should remember it is not like buying mutual funds or exchange-traded funds, which invest in public markets. Secondary private equity is a management-intensive business where experience, skill and track record are crucial to success. The reputation of the secondary fund manager for timely evaluation, discretion and efficient execution is essential to driving opportunities.

It should be noted that while the life cycle of a secondary private-equity investment is shorter than traditional private equity, a time frame of seven to eight years can still be expected. Managers of such investments also require minimum commitments in the $1- to-$5-million range, so they’re not suitable for retail investors, but they can be a nice diversification play for family offices and institutions. **FPM**

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