Secondary Market Goes Mainstream, as Deal Volume Hits New High

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In addition to being a record year for secondary volume, 2014 may be the year that finally smashed some lingering myths about the secondary market.

The idea that the market would attract forced sellers has been fading for years, and all but completely disappeared during 2014 as limited partners, flush with cash from the record distributions of their general partners, shopped portfolios large and small as a way to refine their holdings.

Meanwhile, the dynamics surrounding a nascent part of the market, general partner restructurings, slowly have started to shift. No longer the exclusive province of the lumbering zombie fund, restructurings and the selling of tail-end assets are slowly becoming more commonplace among well-performing GPs, said industry experts.

Those two trends, of portfolio management and of GPs seeking solutions for aging funds, are expected to drive deal flow in 2015, but secondary buyers polled by **Dow Jones** in our annual secondary survey were divided over whether secondary volume in 2015 would match or exceed 2014 levels.

Deal value, which hit record levels in 2014, was driven partly by roughly a dozen billion-dollar-plus transactions that came to market, including portfolios from **General Electric Co** .'s **GE Capital** , **Pennsylvania Public School Employees' Retirement System** and **J.P. Morgan** Chase & Co.

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Do You Expect This Year to Be a Record Year for Secondary Deal Volume?

Roughly two out of three survey respondents said they anticipated 2015 to be a record year for volume as well, citing good pricing for sellers, more opportunities for GP restructurings and an aging set of funds in Asia potentially fueling supply. The survey reflected responses from 57 buyers, including some of the industry's largest players.

Other respondents saw the blockbuster year in 2014 as an outlier, driven by those large portfolios, and didn't expect the same dynamics to materialize during 2015.

Eric Zoller , partner and co-founder of secondary adviser **Sixpoint Partners** , said he was skeptical 2015 would be marked by the same amount of big ticket transactions. The exception may be in real estate secondaries, where Mr. Zoller and others said they anticipated increased activity and larger portfolios to manifest.

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Teapot

Pent-Up Demand

The prevalence of large transactions meant that a handful of buyers accounted for a disproportionate percentage of deal volume, according to Mathieu Dréan, a managing partner at placement agent Triago.

"Other players were equally eager to get deals done," said Mr. Dréan, adding those buyers in the market who didn't deploy as much capital as they would have liked in 2014 have greater incentive to make investments in 2015.

For its part, Triago estimates transaction volume in 2015 will reach between $35 and $40 billion, but predicts fewer large transactions and a wider diversification of buyers.

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Do You See Competition From New Sources for Deals?

Roughly 44% of survey participants said they saw new competition for deals during 2014, from limited partners including family offices, endowments and foundations. The massive wave of distributions that has washed over LPs' portfolios may serve to accelerate secondary buying among LPs as they seek to invest capital quickly.

Through the first quarter, Mr. Dréan said Triago already had transacted with between 12 and 14 unique buyers – a much higher figure than usual.

"In a given year, we usually end up transacting with 22 to 25 distinct buyers," he said, adding that interested buyers run the gamut from dedicated secondary funds, funds of funds, insurance companies, private offices and others.

"The big theme for all LPs these days is to try to optimize the deployment rate," said Mr. Dréan. "They're eager to do secondary deals. They're clearing the deck of massive amounts of money." He added those types of buyers would stick primarily to simpler and smaller transactions.

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What Percentage of Secondary Deals You Do Is Due to:

As it did in last year's survey, portfolio management remains the primary driver of secondary deal volume, accounting for an average of 46% of deal flow among this year's survey respondents, up from an average of 40% in a similar survey conducted last year.

"Many sellers are working on portfolio solutions, but are waiting for the year-end numbers or even the March 31 numbers to come through," saidBenoît Verbrugghe , head of the U.S. office at Ardian. "We think that [in] the second quarter, you will start to see new transactions coming in the market."

Shifts in strategy, staffing changes and an overall appetite to rebalance were among the underlying motivators for some sellers in 2014, said Mr. Zoller. As these types of pruning transactions have become more commonplace, Triago calculated that the average portion of a portfolio that will end up in secondaries is close to 20%.

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Percentage of Funds Going to Small/Large Deals

"No sophisticated institutional investor today thinks about private equity commitments as just 'buy and hold,'" Wilson Warren, a partner at New York-based Lexington Partners told Private Equity Analyst in April. "They know that they will have to do something actively with their portfolio over time, or the portfolio will end up being too disparate."

Don't Bank On Financial Institutions

Regulatory changes in the U.S. and Europe drove an average of about 29% of transactions, according to survey respondents, in line with last year's figures. But industry experts predict that well is close to running dry, as those financial institutions that continue to hold private equity assets on their balance sheets cling tightly to those investments.

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Vault

"Banks and insurance companies ... have been creative in delaying sales in hopes that regulation would change," said Mr. Zoller.

A two-year extension that gives banks until 2017 to comply with the Volcker rule in the U.S. means that such institutions have even more runway to delay a sale. Meanwhile, in early 2015, bank regulators issued guidance on the Volcker rule that appears to allow foreign banks operating in the U.S. more leeway to hold onto certain types of private equity investments.

That said, banks that have held onto assets may have an incentive to sell that's driven more by the generous pricing available than by looming regulatory threats, said Mr. Dréan. "It's a good time to rationalize assets and cash out," he said.

A group of European lenders, including **Standard Chartered PLC** , **HSBC Holdings PLC** and **Unicredit** SpA, were among those who sold large private equity fund portfolios or initiated plans to do so last year.

Perhaps the highest-profile transaction in the bank space last year came as **J.P. Morgan** agreed to sell roughly half its stake in buyout arm **One Equity Partners** to **Lexington Partners** and **AlpInvest Partners** . J.P. Morgan had said its plan to spin off One Equity wasn't in response to regulatory pressure, but rather was a reflection of the firm's uneven returns and uncertainty over where the unit fit within the bank, The Wall Street Journal reported.

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Percentage of Funds Going to Small/Large Deals

Lexington also was behind a deal to buy a substantial portion of a $1.5 billion commitment Citigroup Inc. made to a fund managed by Metalmark Capital. Citigroup moved to shed its ownership stake in Metalmark in late 2013.

One secondary buyer estimated the remaining value of bank-held private equity assets in the U.S. and Europe at roughly $50 billion. That has dwindled from 2014, when professionals estimated that there were between $60 billion and $85 billion of assets left to sell. "Clearly a lot of banks have sold at this point," said Stephen Sloan , a managing partner at secondary intermediary Greenhill Cogent. "We don't expect them to be a growing part of the market, though they do still have assets to sell."

Buyers Become Sellers

Premium pricing also inspired some historical buyers, including funds of funds, to sell portfolios, allowing them to return cash more expediently to their own limited partners. Private Advisors, **Adams Street Partners** ,**HarbourVest Partners** and Pantheon were among the funds of funds that opted to explore options on the secondary market during the past 18 months.

"[Funds of funds] have a view on pricing for most assets they own, and if someone in the market is pricing it materially higher, they're willing to sell," said Greenhill Cogent Managing Director Brian Mooney .

Canada Pension Plan Investment Board , one of the industry's most prominent secondary buyers, is among those taking advantage of favorable pricing, exploring the potential sale of a portfolio of stakes valued at between $1 billion and $1.5 billion, Private Equity Analyst reported in April.

Restructurings Gain Popularity

Despite challenges posed by trying to engineer a fund restructuring, the number of such transactions and the number of buyers willing to attempt them continue to increase.

Landmark Partners estimates that the number of restructurings increased 35% year-over-year in 2014, with the dollar volume of those transactions rising by 140%, according to Partner Ian Charles.

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Did You Participate in Any GP or Fund Restructuring Deals Over the Past Year?

Although GP restructurings accounted for an average of 20% of deal volume among this year's survey respondents, some 60% of our survey respondents said they had participated in a general partner or fund restructuring in 2014.

So-called zombie funds are becoming a smaller part of the market, said Mr. Charles. "Funds with brand-name GPs are now being restructured to provide early, attractive liquidity for LPs who want it, and better alignment and incentives for LPs that want to stay in the fund and GPs that want to improve dynamics around a predecessor fund," he said.

Landmark led one such deal for a 2006-vintage fund managed by **Intermediate Capital Group** , a credit specialist that focuses on North America and Europe. A portion of the fund's existing investors opted to roll over proceeds into the deal, which was financed in part by a small syndicate of investors

Landmark assembled. ICG is in the market seeking €2.5 billion for a new mezzanine fund, Private Equity Analyst reported in January.

HarbourVest, **Morgan Stanley Alternative Investment Partners** and Coller Capital are among the other investors which tackled restructurings and financed spinouts during the past 24 months, according to data provider Preqin Ltd.

Yann Robard , who heads secondaries and co-investments at the **Canada Pension Plan Investment Board** , said these types of deals, which he calls "GP solutions," carry some of the same myths and stigmas the traditional secondary market battled in the 1990s.

"There was skepticism, and it was vulture-like from time to time, but that has completely disappeared now," he said, adding that as more these transactions take place, the industry will get more comfortable with them.

Although restructurings are becoming more commonplace, industry experts agreed their complexity can be off-putting and such deals can still take unexpected turns.

HarbourVest, for example, agreed earlier this year to buy stakes in two **Doughty Hanson** funds, committing an additional €65 million to a planned fund. Doughty Hanson, plagued by departures and meager returns, announced in April it was abandoning efforts to raise a new fund and would focus solely on managing out its remaining assets, **Dow Jones** sister publication Private Equity News reported.

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Business Strategy

"For anyone to be successful in the fund restructuring space, they've got to have creativity, flexibility and partner with right kind of manager who has a good relationship with LPs and can balance the needs and objectives of everyone involved," said Mr. Charles.

"There's still a lot of adverse selection in the market," said Mr. Mooney of Greenhill Cogent. "The deals are complex and there's a lot of conflict involved, but if you can construct a solution that allows the LPs to have an option that's better than the status quo, then it can be a win for everyone."

Additionally, it would appear that in complicated transactions such as restructurings, size matters. In smaller restructurings, "people are hesitant to get involved. It's the same amount of work, the execution risk is higher, and the payoff isn't as great," said Mr. Zoller.

"The overall percentage of deals being evaluated is higher, but the overall number of deals being executed is probably low," Mr. Zoller added. "More and more are getting done, but the amount is less than people think."

Deals From Further Afield

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What Percentage of Secondary Assets Purchased Last Year Fell Outside of Traditional PE or VC?

Even as secondary buyers vie for more typical fund portfolios, they are looking increasingly beyond traditional private equity to pick up interests in other asset classes, including infrastructure, credit, natural resources and real estate. This year, 21% of survey respondents saw more than one-fifth of the assets they purchased last year fall outside of typical private equity or venture capital, up from 15% of survey respondents the previous year and 12% of respondents to a similar survey in 2013.

One asset class that experienced growth in secondary volume last year was real estate, which accounted for an estimated 10% of total secondary deal volume for the year, according to a report by Greenhill Cogent.

Although the locales of sellers and fund stakes are slowly widening, survey respondents predicted a majority of their fund would be used to purchase U.S. stakes.

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Percentage of Funds Going to U.S./Non-U.S. Deals

Respondents predicted they would invest a median of 35% of their current fund in non-U.S. deals, roughly the same percentage as their prior funds, according to the survey data. That figure also is in line with the results from last year's survey.

Industry participants largely expect volume in the U.K., Japan, Brazil, Latin America and Australia to stay the same year over year.

Japan was home to one of the dozen giant portfolios that hit the market in 2015, as **Mizuho Financial Group** agreed to sell a portfolio of about $1 billion worth of stakes to **Lexington Partners** .

Respondents were nearly equally divided over whether volume would increase, decrease or stay the same in Eastern Europe and Russia, which has been plagued by low oil prices and sanctions stemming from its conflict with Ukraine.

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How Do You Expect Secondary Deal Volume to Trend in the Following Regions?

Nearly a third of investors expected some increase in activity in the Middle East. Abu Dhabi Investment Authority reportedly was shopping a portfolio valued at roughly $2 billion in 2014, Bloomberg Businessweek reported.

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Dart Board

A Fundraising Bonanza

Secondary buyers are well capitalized to take advantage of portfolios coming to market, after a robust year for fundraising.

Lexington recently wrapped up its latest core secondary fund with $10.1 billion, ranking it as the largest such fund ever raised. In 2014, meanwhile, several of the industry's biggest names, including Ardian, **Blackstone Group** 's Strategic Partners unit and **Landmark Partners** , built up large war chests, driving total secondary fundraising to $23.91 billion for the year, up nearly 38% from $17.30 billion a year earlier, according to data provider **Dow Jones** LP Source, which, like the publisher of this supplement, is owned by Dow Jones.

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Raising Your Last Fund Was:

Strong performance generated by private equity has helped create a welcoming environment for those secondary firms pitching new funds. Roughly 70% of respondents to our survey described their most recent fundraising as "very easy" or "fairly easy," with around the same percentage completing their funds in about a year or less.

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How Long Did It Take You to Raise Your Last Fund?

As more large players, including Ardian, Coller Capital and Partners Group, seek capital in 2015, however, some industry professionals have expressed doubts about the ability of firms to buy quality assets at competitive prices.

Others argue the amount of capital available to buy secondary stakes is still a fraction of the overall amount of assets available for purchase.

"There's only two years of buying power held by secondary buyers," said an executive at one large secondary firm.

–Laura Kreutzer contributed to this report.