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I cover private equity and its evolution as an asset class.

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As Investors Grapple with Growing Cash Piles, Private Equity's Secondary Market Booms

After receiving record windfalls from realized private equity investments last year, investors are committing as much as they can to high caliber opportunities in the asset class. Buying existing stakes in mature private equity funds on the secondary market is one way to invest more without compromising on quality.

Secondary volume has hit unprecedented highs in 2014, with some $13.75 billion of existing private equity funds changing hands in the first five months of the year and more than three times that amount parked in specialist funds that buy on the secondary market, according to The Triago Quarterly.

What's driving all this interest?

Through the end of April, investors received some $22 billion in net cash from realized private equity investments and from dividend recapitalizations. That comes hard on the heels of record annual net distributions of $120 billion in 2013. High distributions, combined with particularly strong gains in global stock markets since the start of last year, mean more than 40 percent of investors are below their target allocation to private equity, expressed as a percentage of the value of their overall portfolio. Many are rushing to catch up.

But with a record $1.1 trillion of un-invested capital already committed to private equity funds, competition for assets among fund managers is intense. With the prices that private equity funds pay for companies likely to remain near historic highs for an extended period, many investors are concerned about investing disproportionately in the 2014 crop of private equity funds. One way to re-invest the huge cash flows that investors are receiving, while avoiding excessive exposure to the 2014 vintage, is to directly buy in the private equity fund secondary market, or to invest in a specialist fund that will buy secondary market stakes.

Indeed, buying in the secondary market can turn a risk factor – today's exceptionally high purchase prices – into a return enhancer. Those prices and investor eagerness to pay them, mean an exit market where assets already held for several years by private equity funds are sold quickly and at levels that are frequently above carrying values.

With investors realizing that lofty valuations for companies can be taken advantage of through secondary purchases, volume has soared, as has the size of specialist funds investing in the market and the prices that investors pay for the most promising mature funds. Large U.S. buyout funds, the private equity fund category most likely to sell assets via an initial public offering, have seen their average secondary market pricing strengthen to 99 percent of fund net asset value from 93 percent at the end of 2012. IPOs, not surprisingly, are the type of exit where sale values rise the most over the carrying values assigned by private equity fund managers. The shrinking discount in the secondary market for large U.S. buyout funds has coincided with a 25 percent increase in average net asset value for the category since the end of 2012 – a spike driven in large measure by what have been rising purchase prices for private equity portfolio companies.

If the average purchase price in private equity-linked transactions – usually expressed as a multiple of cash flow – falls and the pace at which mature private equity funds realize investments slows, nimble investors in the secondary market should still do well. They'll just shift from today's predominant strategy of paying relatively close to net asset value, in anticipation of a rapid return on investment and asset sales at levels above carrying value, to a strategy focused on discount-generated returns.

The bottom line: watch for the secondary market to soak up a growing share of the unprecedented cash pile that private equity funds have been returning to investors.

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