montana capital partners

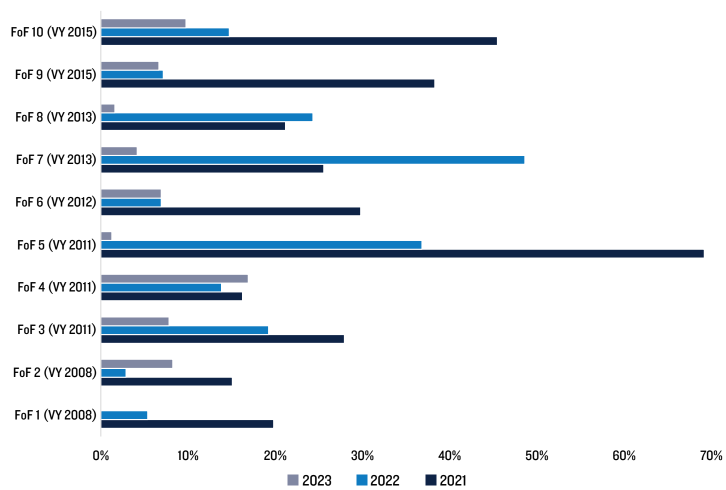
WHY THE PE SECONDARY MARKET REMAINS ATTRACTIVE

Private equity is inherently an illiquid asset class, with money locked in closed-end structures for extended periods, from the time of investment until eventual sale of the portfolio holdings. To address this liquidity challenge, investors often employ diversification as a strategy. By consistently committing to a portfolio of funds over time, they can anticipate a continuous flow of distributions that can be used to cover capital calls. This approach helps mitigate the impact of underperforming funds, as stronger-performing ones can offset shortfalls. Furthermore, the timing and magnitude of capital calls and distributions tend to balance out, minimizing idiosyncratic risks—similar to how diversification works in the public stock market.

However, the analogy with the public market also extends to the systematic aspects of the portfolio that resist diversification efforts. When the tide goes out, ships sink in unison. Despite limited available data, there are indications that this phenomenon is currently playing out in the private equity landscape.

For instance, Burgiss, a reputable collector of limited partner (LP) data, has suggested that 2023 might witness the most significant cash-flow deficits in the industry's history. Similarly, when examining our own funds of funds ("FoFs") holdings, which represent diversified portfolios of private equity funds, it is evident that distributions have significantly dwindled in 2023 compared to previous years.

Exhibit 1: Distributions for Fund of Funds (% of Fund Size)

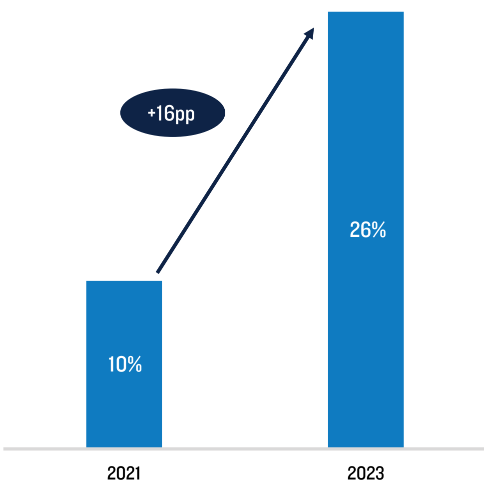


Note: Distributions in relation to fund size for FoFs in mcp's portfolio for the years 2021 to 2023. Distributions in 2023 scaled by 7% as data was obtained on December 6, 2023. Source: mcp 2023.

As can be seen from the chart, the median distributions relative to commitments across the 10 FoFs in our sample have shrunk from 27% in 2021 to 14% in 2022, and were a

Exhibit 2: Liquidity Concerns Have Become the Main Driver of Secondary Market Engagement

Share of investors that consider liquidity needs the main driver



> We see strong tailwinds in the secondary market driven by liquidity needs from institutional investors and expect secondary fund managers to take advantage of attractive deal flow in the near-term.

> We are actively looking into selling investments with managers where we will not re-up in order to generate sufficient liquidity for new investments.

> CVs offer a great exit route for GPs as there is always liquidity issues in downtrends and CVs can generate win-win opportunities.

Notes: Results from mcp's annual investor survey, which gathers the views of institutional investors, such as banks, asset managers, pension funds, insurance companies, and sovereign wealth funds (classified throughout the report as "institutional investors"), as well as reputable family offices and foundations / endowments ("family offices and foundations").
Source: mcp 2023 Annual Investor Survey: Private Equity in the spotlight – how leading investors navigate the slowdown. mcp 2023.

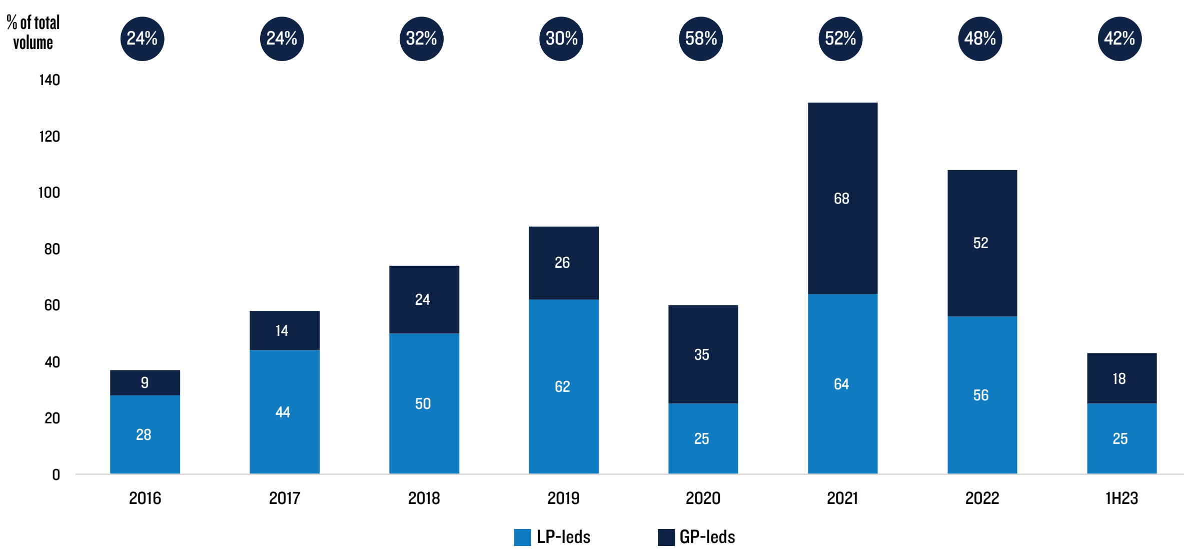
mere 7% in 2023. This substantial decline has caught many investors off guard. As a result, investors find themselves in the position of needing to respond to these changing circumstances. Since they cannot compel their fund managers to sell the underlying investments, their only alternative is to initiate the sale of their fund holdings themselves.

In mcp's annual investor survey, more than a quarter of investors expressed that they are considering selling some of their private equity positions for liquidity reasons, marking a 160% increase compared to 2021.

This quest for liquidity has reignited interest in the LP segment of the secondaries market. Over the past decade, LP transactions steadily declined in favor of general partner ("GP")-led transactions, where the underlying fund managers initiated liquidity options in various forms. However, this trend began to reverse from 2021 onward. In 2020 and 2021, GP-led transactions dominated the market, but by 2022 and 2023, LP-led transactions regained prominence, as evidenced in the following chart.

Exhibit 3: Driven by Macroeconomic Factors, the Secondary Market Continues to be Attractive

LP-led/GP-led Split ($USD Billion)



Sources: Jefferies 2023 Global Secondary Market Review (July 2023).

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