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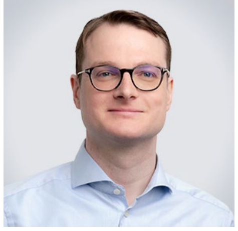
THE DIFFERENTIAL

IN CONVERSATION WITH IAS

IAS's Aili Chen discusses recent trends, risks and opportunities in the secondary private equity market with Christoph Jäckel, Managing Partner of Montana Capital Partners. PGIM acquired Montana Capital, a leading secondaries player, in 2021.



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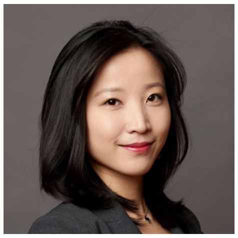

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Christoph is a Managing Partner of Montana Capital Partners. Before joining mcp, Christoph was a research assistant at the Department of Financial Management and Capital Markets of the Technical University of Munich. His dissertation dealt with the computation and evaluation of alternative expected return proxies for stocks and was partly written during his stay as a Visiting Scholar at UCLA Anderson. In addition, Christoph gained international work experience at Kolbenschmidt Pierburg in Shanghai, Capital Dynamics in Zug, and Lehman Brothers in London. Christoph holds a Dr. rer. pol. in finance from the Technical University Munich and a diploma degree in business administration specializing on capital markets and operations research at the Technical University of Munich.

Aili Chen is Vice President in the Institutional Advisory & Solutions (IAS) group, focusing on asset allocation and portfolio construction research using systematic, data-driven methods. Before joining PGIM in October 2021, Aili was Vice President and Quantitative Investment Strategist within Morgan Stanley's Global Investment Office. She developed asset allocation, portfolio construction, and security selection recommendations for financial advisors and clients. Before Morgan Stanley, Aili was a Senior Associate in the Quantitative Advisory Services of EY. Aili earned her BA degrees in Economics and International Relations from China Foreign Affairs University and her MA in Economics from Cornell University.

AC: Secondary Private Equity (PE) investments play an increasingly important role in institutional portfolios. Could you provide an overview of how the private equity secondary market operates? Who are the main participants in this market?

CJ: I always like to use the metaphor that we in the secondary market of private equity are essentially the "stock exchanges" of the private equity markets. We allow owners of private equity funds (i.e., limited partners or LPs) to trade their assets – but their assets aren't stocks – they are private equity fund shares.

The differences are that this market is much less liquid and much less regulated than the public market. If you want to sell a share of Apple stock, you can do so by a push of a button. If you want to sell a share, say, in a Blackstone private equity fund, it's not as straightforward. The process takes much longer. It often takes weeks, if not months, to go from the decision to sell to actually selling.

In addition to the LPs buying and selling, fund managers (i.e., the general partners or GPs) are important participants in the process. They facilitate the process by sharing information and they must approve the transfer.

Intermediaries, usually bank divisions or independent firms, also play a role to help source deal flows, especially for larger portfolios in wellknown funds.

AC: When would an LP consider selling its PE fund interests in the secondary market? And when would a GP initiate a "GP-led" secondary transaction?

CJ: On the LP side, we have come "full circle" in the secondary world. Initially, the main reason was for liquidity – when LPs need to convert their investments into cash to meet unexpected cash requirements. The 2007-2008 financial crisis acted as a great catalyst for the growth of the secondary market by creating a strong need for investors to sell their private assets for liquidity.

This has changed over the years as other drivers for secondary transactions emerged: portfolio management, change of investment strategy or getting rid of non-core positions.

However, according to our 2023 Annual Investor Survey, liquidity has again become the No. 1 reason for selling in the secondary market, which hasn't been the case for several years. In 2023, around 25% respondents cited liquidity as the main reason to sell their PE holdings and another 16% respondents said that they are over-allocated to PE – so back to the traditional reason of selling in the secondary market – liquidity. That's why I called it a "full circle."

In a "GP-led" secondary transaction, bear in mind that the GP is not the one selling. There are different types of GP-led transactions (e.g., a tender offer), which the GP facilitates for an external buyer (e.g., a secondary fund) to buy fund interests from existing LPs.

Currently, the most common GP-led secondary transaction is when the GP creates a "continuation vehicle" and sells a fund's portfolio assets into the new vehicle. In such a transaction, the GP is essentially "fundraising" to hold onto the underlying assets for longer. This is because, if you, the GP, see a lot of upside in an asset, why would you want to sell it after only four or five years? You may want to keep those great assets for longer. In addition, selling a business would incur huge costs including fees to lawyers, M&A firms and due diligence providers. Also, for the portfolio company's management team, they have to get used to a new owner. A continuation fund can provide solutions to these challenges.

In short, the motivations for the GP in these GP-led transactions are to provide additional time and capital for these assets to mature and reach their full value potential while minimizing the cost of selling.

AC: What is the role of secondary PE investments in an investor's portfolio, and what are the liquidity characteristics of these investments?

CJ: Secondary PE investments have several advantages for an investor's portfolio compared to primary PE investments. A secondary PE investment typically has shallower and shorter "J-curve effect" with quicker distributions than traditional PE funds. This is because when the investor buys a secondary investment, the fund has already held onto the underlying portfolio companies for a few years. This is also attractive for an investor who wants to ramp up their PE exposure quickly, because they get access to prior vintage years that they otherwise would not be able to access. You get diversification across vintage years, sectors, geographies, strategies, and managers.

A secondary fund is typically well diversified across a dozen of primary funds and several hundreds of underlying portfolio companies. And you can argue that secondary funds can be counter-cyclical. 2023 is a good example when IPO and M&A activity fell drastically compared to secondary deal volume. When liquidity is needed and distributions dry out, secondary funds can provide liquidity to sellers and offer a great liquidity premium for buyers. Historically, secondary fund returns have been less volatile compared to those for primary funds and the "return band" – the range of possible return outcomes – has been much narrower.

AC: Could you explain how valuation works in the PE secondary market, and how it differs from the primary market?

CJ: Let's start with the primary PE market. Interestingly, valuation in the primary PE market is generally more complex and more difficult to understand compared to the secondary market. Going back to the example of Apple. It's not that Apple, the company, issues an opinion every quarter on how the company should be valued. Instead, the price of Apple stock is determined by trading in the secondary market.

In private equity, however, since you don't have a secondary market that trades frequently, investors rely on the GP to provide them with a valuation. Though there are guidelines, the GP has a lot of leeway in how they arrive at a valuation.

How does a secondary buyer price a fund? The first step is for the buyer to come up with a cash flow profile of each underlying company investment by running a valuation exercise to predict the proceeds from the investment. To do so, they look at the business model, growth options, financials, peers, etc. The second step is for the buyer to take into consideration everything that happens at the fund level (e.g., fees, carried interest, unfunded commitments). Together, this gives the buyer a full picture of all cash flows that they can expect from the fund, with which they can decide how much they are willing to pay for the fund. That price is communicated as a discount or premium to the NAV that the GP is providing to investors.

AC: How has the private equity secondary market evolved over the last decade? What have been some significant changes?

CJ: The most significant change has been the birth of GP-led transactions. A decade ago, secondary transactions were all "LPled." Now, we see a roughly 50/50 split. The GPs are initiating many more transactions, and this has been the most fundamental change in the secondary space.

In addition, the market has become much more mature with a broader toolset. Initially, we only had simple LP transfers, now you have deferred payment structures, preferred equity, earn out mechanisms, NAV loans, and even more customized structured solutions that involve modification and restructuring of the standard distribution waterfall that dictates the order in which profits are distributed.

In short, the sophistication of the market has increased as has the range of possible solutions that a secondary buyer could offer to a counterparty.

AC: We've had a low-rate environment for a long time but that seems to be changing. What would it mean for private equity if the cost of capital is now persistently higher, with inflation more stubborn?

CJ: Higher rates and higher inflation mean higher expected returns! When we were in a low-rate environment, expected returns were low and realized returns were high. Now we are in this new phase where expected returns have increased with interest rates, while realized returns have come down as asset value has come down. This large increase in the cost of capital due to the unexpected increase in inflation took a few PE participants by surprise, but certain business models are impacted more than others.

As rates increase, so does the cost of financing for M&A transactions, which rely heavily on third-party leverage. Similarly, IPOs have experienced a sharp decline in deal volume since 2021 compared to previous years. To make things worse, since GPs are reluctant to mark down their NAVs in response to higher rates, there's been a gap between a GP's valuation and the price secondary buyers are willing to pay. As a result, the opportunities for fund exits (i.e., sales of portfolio companies) diminished and the distributions to investors consequently dried up. Interestingly, we saw that capital calls have not decreased in tandem as GPs continued to call capital in order to pay off their outstanding subscription lines of credit used to finance old acquisitions. In combination, many PE investors got much less capital out of their portfolio than expected.

However, this new regime has created opportunities for some players. Some investors in need of liquidity have turned to the secondary market which creates attractive opportunities for buyers.

AC: It's interesting that you mentioned subscription lines of credit. Increased use of subscription lines by GPs to boost returns has been a concern in the primary private equity market. Are they also prevalent in the secondary market?

CJ: Credit lines can be used to inflate returns, but they can also be used to make cash flow management simpler. As a GP, it is a huge relief if you have a transaction closing and you do not have to worry about any delay in receiving called capital from LPs. In my opinion, there will always be a place for credit lines.

For secondaries, that reason is much stronger. Why? Because with more frequent transactions, we need to deploy capital and close deals more quickly than is the case for primary funds. We are not doing three or four investments per annum but eight, ten or 12 investments, and then in several underlying funds.

On top of that, subscription lines have been used for performance enhancement. Economically, it is completely rational with interest rates close to 0% and a hurdle rate of 8% that private equity funds typically must hit. It makes sense to use "costless money" to finance as many portfolio asset acquisitions as possible. This of course will change now, with credit costing close to the hurdle rate.

By the way, I conducted a study on credit lines and found that credit lines improve IRRs meaningfully only in most strongly performing funds and funds early in their life. In the long-term, the effect of a credit line on IRR is limited.

AC: What advice would you give to a new institutional client looking to invest in the secondary market? What should be the key considerations?

CJ: New investors should make sure to pick a secondary fund manager that gives them the traditional benefits of a secondary fund (e.g., diversification and early money back).

The secondary market has become more and more sophisticated with more and more niche strategies. Some of these strategies do not offer the traditional secondary market benefits if that is what the investor is seeking.

Also, make sure to consider the different degrees of leverage. This is very important for a secondary fund to get right. We have leverage on the underlying company level, we also have credit lines on top of that and NAV facilities, whole portfolio leverage or acquisition leverage. Be fully aware of the different degrees of leverage when comparing across secondary funds and make sure you are comfortable taking these risks.

Choose a partner with whom you could build a good rapport and who could help you build your knowledge. These relationships can be a two-way street offering mutual benefits. Good secondary funds often know a lot of good PE managers and they can be your sounding board as you explore this new area.

AC: Thank you, Christoph!

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IAS AS 0731-400