

# The Growth of the Secondary Transaction Market

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## Challenges and Opportunities Going Forward

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23rd September 2021



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## Introduction

Despite the economic and global health challenges that the pandemic brought in 2020, the year also presented an incredible opportunity in the secondary private equity market that had not been seen since the Global Financial crisis in 2008. Investors are usually attracted to the secondary market due to the possibility of taking advantage of its structural and cash-flow benefit, as well as its ability to capitalise on market inefficiencies. Thus, the growth we've seen in this market does not come as a surprise.<sup>1</sup>

## What is the Secondary Private Equity Market?

Investors can access the private equity market through either primary or secondary transactions. While investments in the primary equity market are made directly into newly formed private equity funds, in the secondary market, investors purchase existing limited partner private equity interests that are made available on the market by other limited partners.<sup>2</sup> Thus, the secondary private equity market is where equity from a firm is bought or sold, and new investor commitments are created.

Usually, private equity investments are very illiquid, and thus it remains rather difficult to buy and sell in this market. Nevertheless, because of the increasing demand for private equity since the 1980s, the secondary private equity market has been developing rapidly.<sup>3</sup>

As such, the private equity secondary market has seen a long-term secular boom. In fact, despite the effects of the pandemic, it witnessed an explosive year, being the second busiest year for secondary transactions, reaching a volume of \$71 billion. This is down only 14.5 per cent compared to its all-time record in 2019, where transactions reached a record of \$83 billion. Moreover, market pundits are predicting that secondary transactions will top the \$100 billion mark for the first time ever, later this year.<sup>4</sup>

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<sup>1</sup> <https://www.adamsstreetpartners.com/insights/secondary-market-outlook/>

<sup>2</sup> <https://pomoinvestmentfund.com/why-secondaries>

<sup>3</sup> <https://www.divestopedia.com/definition/5166/private-equity-secondary-market>

<sup>4</sup> <https://www.forbes.com/sites/antoinedrean/2021/06/21/the-key-to-private-equitys-growth-is-the-booming-secondary-market/>

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## The Increasing Appeal of Secondaries

There are clear reasons for this demand as the benefits of secondary transactions apply to both sellers and buyers. For buyers, secondary transactions create entry options and value creation opportunities atop their already existing assets. More precisely, secondary transactions have significant impacts on liquidity. The purchase of secondary transactions allows for shorter investment periods as the purchased assets will already be relatively mature. In addition, such a faster capital return often leads to higher annual returns – even if not necessarily higher multiples on the initial investment – than taking the primary fundraising route.<sup>5</sup> Consequently, this allows for investors to “mitigate the J-curve.”<sup>6</sup> This refers to how private equity funds typically have “negative” returns in the first few years (due to investors having to pay management fees and other initial investment costs) that eventually turn into positive returns as the investment matures.

For sellers, they provide solutions to the private market's systematic needs.<sup>7</sup> More precisely, the sale of limited partner-held fund stakes allows for the generation of a steady stream of capital to be deployed into new investment opportunities. Thus, secondary transactions can be used by funds to manage otherwise illiquid private equity portfolios. In their most complex form, asset and fund restructuring (referred to as GP-led deals), provide a way to raise capital, or maintain promising assets for more than the typical 10-year private equity term.<sup>8</sup> In fact, such GP-led deals make up 50 per cent of today's deals by volume, with this market expected to have another record-breaking year.<sup>9</sup>

In addition, the demand for green alternatives in finance is also driving the growth of secondaries. The increasing importance of ESG factors means that investors are choosing to sell their non-green assets in order to align their portfolio's with ESG requirements and goals. This is typically reflected by firms reducing their exposure to oil and gas equity to align with new guidelines.

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<sup>5</sup> <https://www.forbes.com/sites/antoinedrean/2021/06/21/the-key-to-private-equitys-growth-is-the-booming-secondary-market/>

<sup>6</sup> <https://pomoinvestmentfund.com/why-secondaries>

<sup>7</sup> <https://www.campdenfb.com/article/secondary-none-potential-benefits-private-equity-secondaries-market>

<sup>8</sup> <https://www.icapitalnetwork.com/insights/private-equity/secondary-private-equity-funds/>

<sup>9</sup> <https://www.privateequitywire.co.uk/2021/06/02/301231/evolving-opportunities-secondary-market>

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Thus, what we are seeing is a culture shift among institutional investors. Previously, secondary sales were viewed as synonymous with distressed sales, with such sales being viewed as a sign of the end of the relationship between the GP and the LP. If an LP was selling its stake into a GP, the GP would often consider the LP as a distressed investor who is not able to invest in its future funds, or an investor who lost confidence in its ability to manage funds.<sup>10</sup> However, due to recent trends, increased participation in the secondary market is seen as beneficial and effective, instead of it being viewed as a stigma.<sup>11</sup>

Moreover, an increasing number of GPs are raising funds for secondary transactions by specialising in niche strategies. Because private equity is a rich asset class with multiple subsegments, this allows almost endless opportunities for fund managers that wish to raise capital in a secondary fund. For example, in the past decade, Blackstone has launched a secondary activity under the brand Strategic Partners and now manages dedicated funds for the real estate and infrastructure sectors.<sup>12</sup>

## Challenges and Opportunities Going Forward

One upside of market volatility that secondaries are experiencing is that the market is expected to potentially adjust downward, leading to increasingly more attractive opportunities for fund managers and investors. As highlighted previously, the secondary market has been trading at all-time high levels. Ultimately, these elevated pricing levels have been leading to compressed return expectations. In the future, a downturn-driven reset would mean that the secondary market can re-adjust to lower valuation levels, allowing fund managers to acquire positions at lower prices.

However, it is yet to be seen if these secondaries will be able to deliver returns at a premium to public markets, with pockets of the market remaining relatively untapped. Ultimately, this market has been driven by a handful of funds towards the larger end of the market, with less capital reaching smaller secondary funds. As such, while GP-led deals did hit record numbers last year, only a small proportion of overall GPs have pursued such deals thus far.<sup>13</sup>

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<sup>10</sup> <https://alexandre.substack.com/p/-casting-a-light-on-the-private-equity>

<sup>11</sup> <https://www.privateequitywire.co.uk/2020/07/27/287932/secondary-pe-market-primed-strong-growth>

<sup>12</sup> <https://alexandre.substack.com/p/-casting-a-light-on-the-private-equity>

<sup>13</sup> <https://www.privateequitywire.co.uk/2021/06/02/301231/evolving-opportunities-secondary-market>

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Another factor that investors should consider is that while secondaries can provide a mitigated J-curve and a faster return capital, the cashflow profile of secondary funds is ultimately dependent on distributions. If distributions decrease (as is likely in the current recessionary environment), return profiles could lower. As such, it remains key to select disciplined fund managers who are especially focused on downside protection and also have a proven history of navigating market cycles. Consequently, as with any private equity investment, manager selection remains a key aspect to realise the strategic benefits of the investment.<sup>14</sup>

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<sup>14</sup> <https://www.icapitalnetwork.com/insights/private-equity/secondary-private-equity-funds/>





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