Hamilton Lane Research

AN OFFER YOU CAN'T REFUSE: WHY YOU SHOULD BE A SECONDARY SELLER

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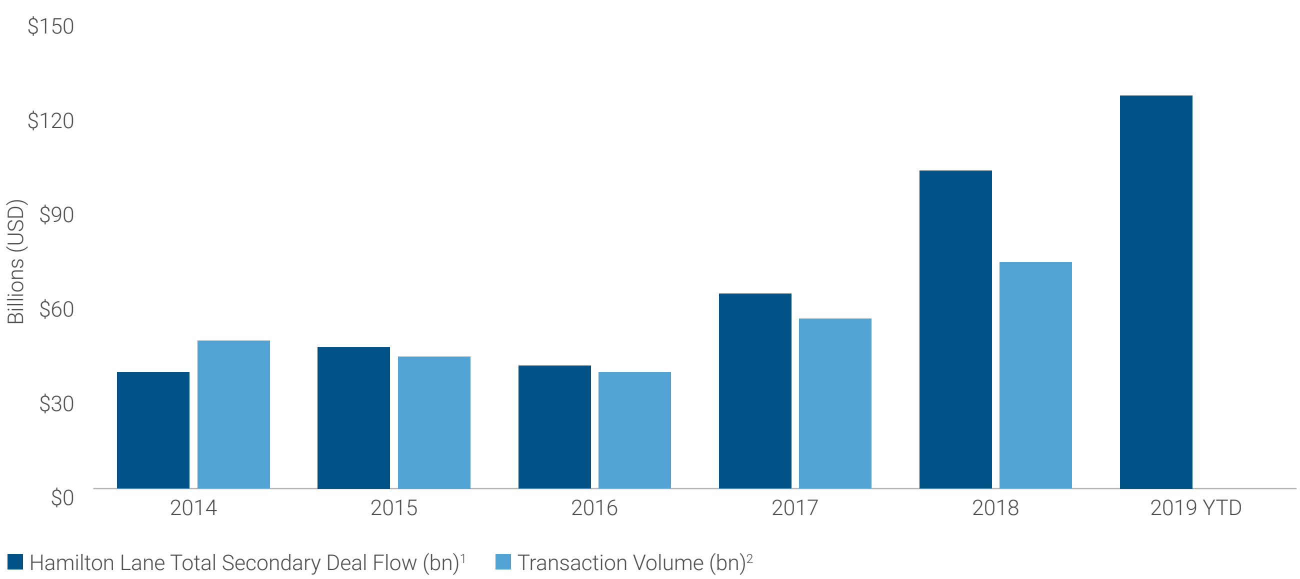
In the 1972 film classic, *The Godfather*, Marlon Brando's title character is asked how he will make a stubborn man see things his way. His response, "I'll make him an offer he can't refuse," is emblematic of the way he approaches issues. By turning potential problems into win-win solutions, both parties can benefit.

The same might be said about the private equity secondary market. Once a niche sector of the private markets landscape, secondaries have officially gone mainstream over the last few years. Media coverage abounds, whether about the latest transaction or exploring some emerging trend within the market.

While there are benefits to participating in a growing and evolving market, the level of complexity and specialization has increased, posing a challenge to limited partners looking to ramp up their exposure or allocate to secondaries for the first time. It is against this backdrop that we offer some considerations that can help LPs navigate the secondary market and expand, evolve or reshape their private market portfolios.

It may seem like a distant memory, but it was not long ago that the majority of secondary market sales were executed out of necessity – when liquidity was tight, capital calls were looming and the broader market was in distress. It is quite a different picture today, with the selling of fund stakes now an integral component of prudent portfolio management.

Hamilton Lane Total Secondary Deal Flow

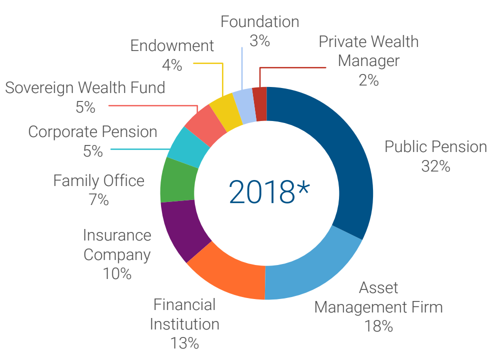


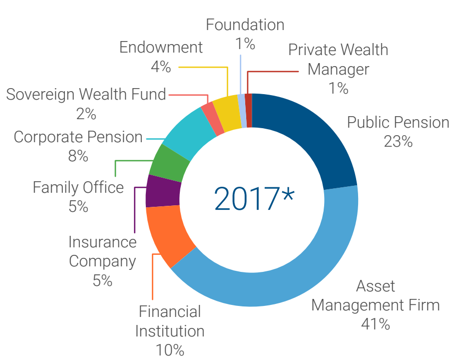
[1] Hamilton Lane data (October 2019)
[2] Source: Evercore PCA Secondary Market Surveys 2014-2018; Preqin, Dow Jones Private Equity Guide to the Secondary Market (2015)

The best way to visualize this change is to look at the increase in deal flow volume in the secondary market over the past five years and contrast that with the current financial backdrop, where markets are rising and institutional investors are struggling to put money to work. No longer are distressed or forced divestitures the predominant catalyst for a transaction. Instead, LPs increasingly are viewing secondary market sales as a way to reshape their portfolios for a wide variety of reasons, which may include:

- Funds that are non-core to their private equity strategy
- Rationalizing number of GP relationships
- Performance, access or succession issues
- Strategy drift within the general partner community
- At target allocation and redeploying into core managers
- Significant remaining net asset value, but low level of distributions
- Over-exposure to a single company or industry
- Reverse denominator effect

Types of Seller in 2017-2018





Source: Campbell Lutyens 2019 Secondary Market Volume Report
*Split by transaction value (purchase price plus unfunded) per respondent.

"No longer are distressed or forced divestiture the predominant catalyst for a transaction. Instead, LPs increasingly are viewing secondary market sales as a way to reshape their portfolios..."

See what we mean? These examples demonstrate that there are a number of motivations driving potential divestitures, as well as multiple ways to cross the finish line. None of these examples are considered unique in today's market, whereas most would have been at the turn of the decade.

Changes in leadership also can precipitate a decision to sell down holdings. We have observed instances of new CIOs who decide to take the portfolio in a new direction, and thus look to offload fund stakes. Newer board members may also demonstrate a tendency to approve or reject fund sales differently than their predecessors.

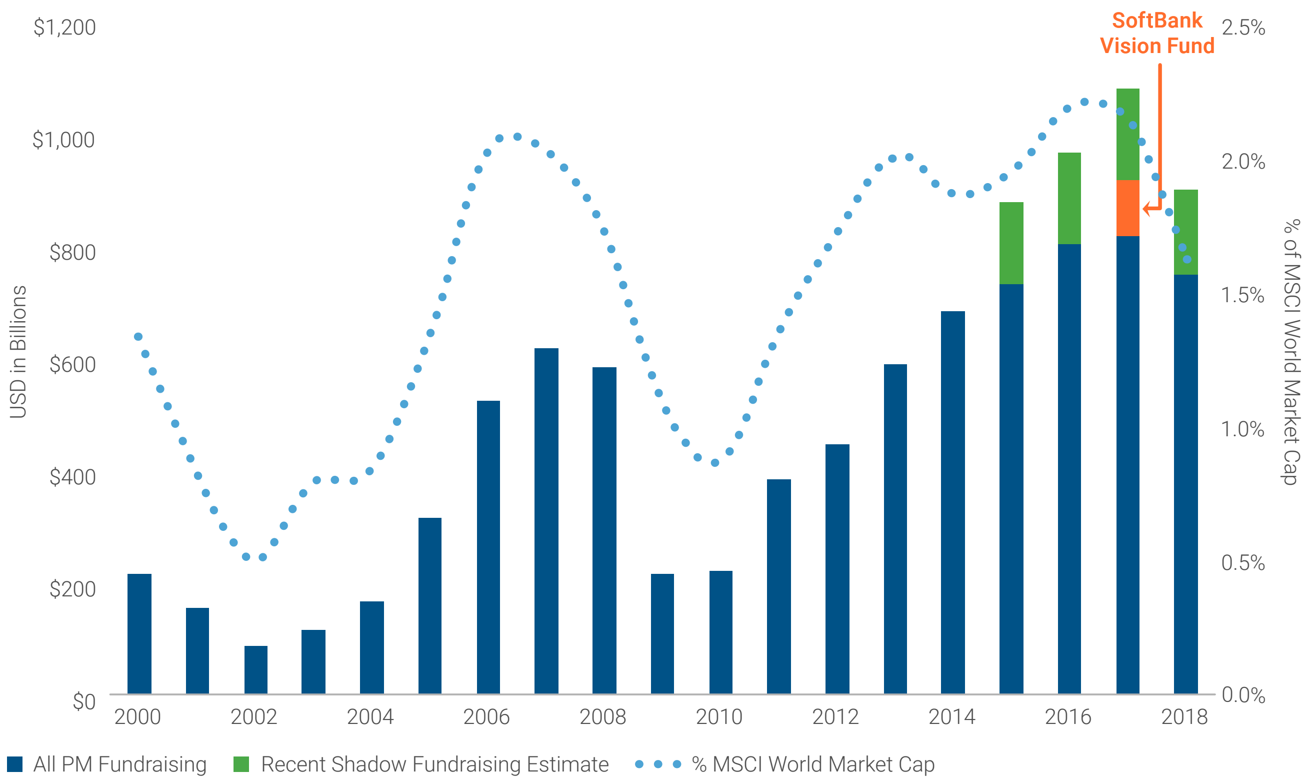
We have seen one notable example of portfolio rebalancing in the current state of affairs of a domestic LP. The new CIO concluded that the plan held too many GP relationships, and is now attempting to create a much more concentrated portfolio with deeper relationships. As a rebalancing was being contemplated, one of the main points of consideration pertained to opportunity cost and cost of capital. If the money currently tied up in certain funds could be redeployed elsewhere, earning a higher return, then it would make sense to sell. Ultimately, the LP concluded that its pipeline of future investment opportunities outweighed the return potential of a portion of its current holdings, and it sold a mix of funds at various price points. In doing so, the seller was able to utilize this capital in ways it believed would better position its portfolio for future growth.

This is only one example, and a prominent one at that. And yet, we believe it is reflective of the manner in which other investors are approaching the secondary market today. We don't expect to see a reversal in terms of overall secondary volume anytime soon. Some of that belief stems from observations that LPs who have conducted a successful sale are more likely to pursue additional sales in the future. Another element has to do with the fact that, in any given year, 1.5-2% of all private capital raised changes hands in the secondary market. As fundraising booms in the private markets, this will provide a natural tailwind to volume, as seen in the chart below. Additionally, some of the largest vehicles raised recently have been dedicated secondary funds providing an increasing amount of dry powder.

When does this part of the market hit its peak? We're not sure that it will. Yes, private fund commitments are "illiquid." Yes, most have a ten-year capital lockup. But do they really? With the ability to sell holdings becoming easier every year, there is no need for investors to perpetually retain vehicles managed by non-core sponsors.

As we move into the next decade, the secondary market is well-positioned to expand in terms of type, scope and size as the market matures. Growth also will be driven by institutional investors that have made their maiden allocations to the private markets or that are expecting to do so in the near term. Naturally, a broader base of limited partners eventually leads to a deeper pool of sellers. And, if we may be so bold as to end this piece looking into the future, we think annual trading volume could potentially reach $200 billion in the next decade based on the past several years of growth. Marlon Brando would be proud.

Global Private Markets Fundraising



Source: Bison Data via Cobalt, Preqin, Bain, Hamilton Lane Estimates. Fundraising data includes real estate, secondary funds and fund-of-funds (February 2019)

Definitions

All Private Markets – Hamilton Lane's definition of "All Private Markets" includes all private commingled funds excluding fund-offunds, and secondary fund-of-funds.

MSCI World Index – The MSCI World Index tracks large and mid-cap equity performance in developed market countries.

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