Secondary Funds: Adding Value to Private Equity

by Brian Boyer

An important element of Wespath's investment philosophy is achieving diversification across a variety of asset classes; private equity (PE) serves an important role in achieving diversification within a portfolio of public equities. Over the past 10 years, Wespath has invested more than $500 million in this asset class—benefitting from the cash flow and valuation changes that have been non-correlated with the public markets. Historically, Wespath has accessed domestic and international PE investments through fund-of-funds (FOF) managers.

Through its FOF managers, Wespath has invested the large majority of its PE capital in traditional primary PE funds, in which capital is committed up front and drawn down over a defined investment period, usually five years. In an effort to add diversification in its private equity portfolio, Wespath recently committed to a PE FOF strategy that is dedicated to making secondary PE fund investments. In this alternative strategy, PE fund investments are purchased on a "secondary" basis from investors who have decided for a variety of reasons to exit the PE market and wish to sell their primary PE fund investments. Secondary PE investing offers many advantages including immediate exposure to the PE asset class, the possibility of higher returns (since the investment is further into its lifecycle), added diversification and enhanced performance in a broad-based PE portfolio.

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Primary PE Investing

In a typical PE FOF strategy, Wespath and other institutional investors make a commitment to a PE FOF manager's commingled fund vehicle. Commingled fund vehicles are formed so that a group of investors can share ownership in the underlying investments through a specialized fund structure, such as a limited partnership or limited liability company. The FOF manager will identify suitable PE primary funds in which to commit investor capital. The investor capital is then drawn down over a specified investment period of five years, and ultimately returned at the end of the fund life, which can last up to 10 to 12 years. The PE primary fund managers in turn invest the FOF capital in attractive PE investments. They may purchase public or privately held established businesses or they may invest in startup companies through venture capital funding.

Selling Interests in Private Equity

Subsequent events may preclude an investor from honoring its commitment to invest in primary PE funds. Among the reasons an investor may be unable to honor its commitment includes the need to raise immediate cash to meet operational or other conflicting commitments; conserving cash by avoiding future fund capital calls; divesting as a result of regulatory decisions; or, the need to reduce a current allocation to PE.[1] Accordingly, investors may seek to sell their interests in PE funds via a secondary market transaction. As a point of clarification, in a secondary sale, the seller of the PE interest is typically an existing fund investor who desires to exit before the contractual end of the fund. Secondary transactions normally require the express approval of the fund manager or general partner. During and after the secondary transaction, the fund continues to function normally, making regular capital calls. Most of the other limited partners usually are not aware that another limited partner's interest has been sold and transferred to a third-party.

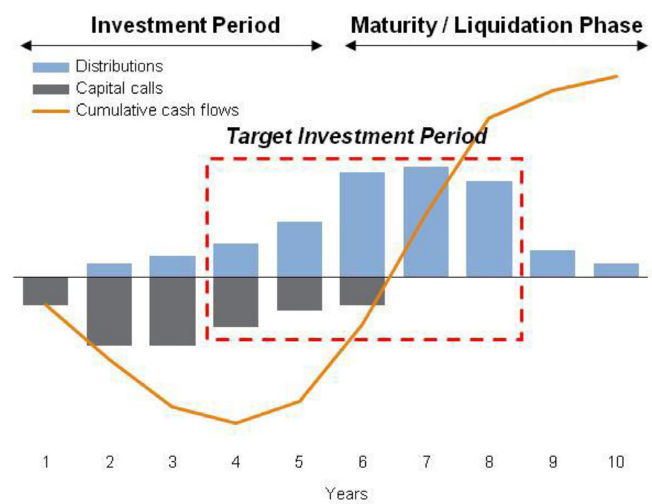
Market for Secondary Transactions

The secondary market for PE represents a loosely organized network of buyers and sellers. While this network offers a chance for investors to sell their interests in highly-illiquid PE investments, it also offers an opportunity for investors looking to buy interests in those investments. There are several reasons why a buyer might choose to participate in the secondary market for PE interests, including:

1) The ability to gain immediate exposure to PE—Secondary investments offer a quick way to invest significant capital in a short period and gain exposure to the PE asset class. Without access to secondary transactions, an investor must wait for the conclusion of the relatively long (on average five to seven years) investment period of a typical primary PE fund until all capital is invested. In a secondary transaction, the investor is acquiring a fund which has already drawn all or part of the designated capital commitment. The investor is therefore effectively entering the fund when it is partway or even halfway through its life.

2) Mitigating the impact of fees and other charges early in a fund's lifecycle—a secondary investment will have a shorter holding period and can lead to a faster return of the investor's capital, since it is typically made during or after the period in which the PE fund is making its investments. The PE fund will likely have already experienced the negative part of the "J-curve"—which refers to negative returns in the early years of the fund's life due to fees and other fund charges that generally overwhelm any preliminary positive investment returns. [The typical pattern of cumulative returns resembles the letter, "J"—negative in the early years and transitioning to positive in the later years (*See Chart 1*).]

Chart 1—Illustrative Cash Flows for a PE Primary Fund



Source: JPMorgan

3) Added diversification—Secondary investments may provide access to PE managers and vintage year funds that investors do not have in their existing primary portfolios, thereby augmenting the diversification of their overall PE portfolio.

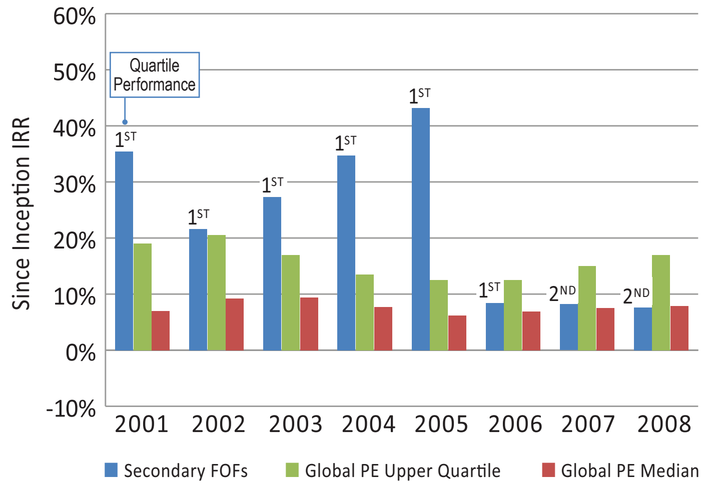
[1] JP Morgan Insights article: "Secondary Private Equity – Investment characteristics and market outlook", p. 3

4) Enhanced returns to PE primary portfolios—According to fund manager Adams Street, purchased secondary interests contributed positively to overall PE performance when compared with primary funds. It is not meaningful to make direct comparisons between secondary and primary fund performance, due to the fact that secondary interests may be acquired at any time, whereas primary fund performance is measured from the "start date" or vintage year in which the first investment is made. Wespath's PE FOF managers have an extensive array of data on the impact of secondary fund performance, due to the fact that they have been active purchasers of secondary fund interests for at least the past two decades. Their experience supports the conclusion that secondary fund interests are accretive to overall PE performance when combined with a portfolio of primary funds. In fact, secondary fund interests purchased by Adams Street between 1986 and 2012 provided top quartile returns in 22 of 23 years, relative to the universe of primary funds originated during the same period.

While Adams Street may have a particular talent in selecting secondary funds, a broader view of secondary fund investing confirms similar positive performance across the industry. Cambridge Associates, a large alternatives investment advisory and consulting firm, has been tracking dedicated secondary PE FOFs and their performance since the early 1990s. *Chart 2* illustrates that during in the 8-year period leading up to the Lehman crisis (2001-2008)—when secondary funds were particularly active—the median return for dedicated secondary funds handily exceeded the median return for the average primary fund of the same vintage year. In fact, the median return for dedicated secondary funds outperformed the top quartile return for primary funds in four of those same eight years.

> It is important to note that most institutional investors do not invest exclusively in secondary interests at the expense of more traditional primary fund PE programs.

Chart 2—Performance Comparison between Secondary FOFs and Global PE Funds (Adams Street Partners)

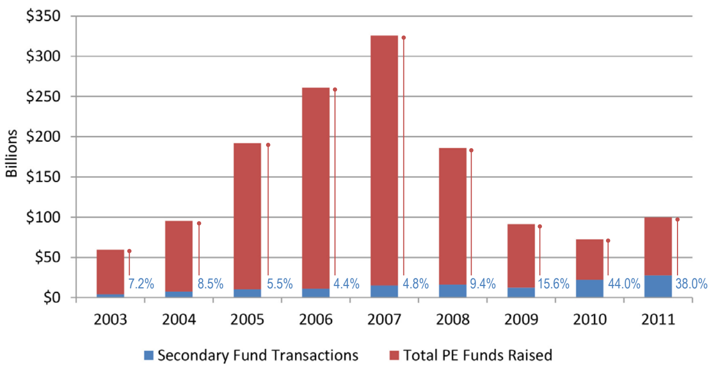


Source: Adams Street Partners

Secondary Investment Opportunities in a Diversified PE Portfolio

Based upon performance, one might be tempted to conclude that investors should only consider acquiring secondary fund interests when building an allocation to PE. However, secondary fund transactions represent a relatively small subset of the available universe of PE investments. It is important to note that most institutional investors do not invest exclusively in secondary interests at the expense of more traditional primary fund PE programs.

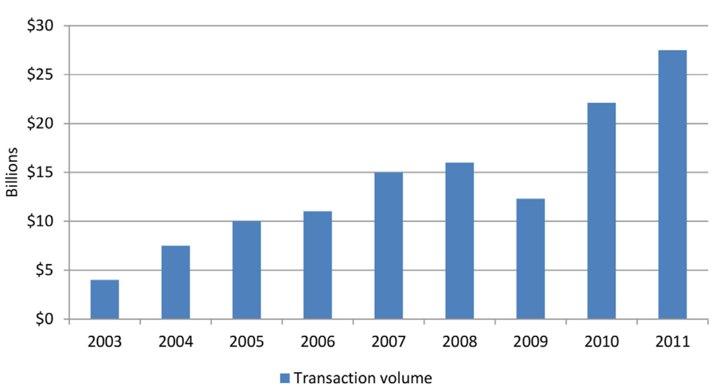
Chart 3—Secondary Transactions vs. Total PE Funds Raised



Source: JP Morgan Asset Management

Chart 3 shows the fraction of capital committed to secondary funds as compared to primary funds. Secondary deal volume has averaged less than 10%, and has never been more than approximately one-third of total primary fund raising in any given year during the last decade. While secondary fund transactions have increased compared to direct capital commitments to PE funds, this increase is generally attributed to a significant decline in direct fund raising following the 2008 market crash, as many large investors have focused on more liquid investment strategies.

Chart 4—Secondary Transaction Volume



Source: JP Morgan Asset Management

One drawback to secondary transaction investing is that the supply of secondary transaction interests is quite variable and often a function of prevailing market conditions. While the volume of secondary transactions has increased overall in the past—particularly in the last 10 years—secondary transactions declined significantly following the 2008 market crash. *Chart 4* shows this phenomenon more clearly.

The chart can be disaggregated into three time periods, showing the fluctuation in secondary deal volume. For example, in the bull market between 2003 and 2007, secondary transaction volume increased approximately threefold. Then, immediately after the market crash, secondary transactions dropped off. Since 2009, secondary transactions have accelerated once again.

Outlook for PE Secondary Transactions

How does the market augur for secondary transactions in the current economic recovery? Is it still an attractive sector for investors? The Wespath team believes the answers to these questions are affirmative for a variety of reasons. First, a significant industry participant, JP Morgan, foresees that the supply of transactions will be robust:

"We expect financial institutions and pension plans, accounting for 75% of the…secondary transaction volume to remain the dominant sellers of private equity interests over the next two years."[2]

One of the anticipated drivers of increased secondary activity is regulatory in nature. In the U.S., the implementation of the Dodd-Frank act (financial legislation passed in the aftermath of the Lehman crisis) will prohibit banks from investing in PE and potentially force them to divest previously-acquired PE interests through secondary sales. In addition, European and U.S. banks are subject to the Basel III regulations, which require large financial institutions to increase capital funding ratios and decrease exposure to illiquid alternative investments, such as private equity. Finally, private U.S. pension plans are expected to continue to be sellers as they rationalize the number of PE managers they utilize.

[2] JP Morgan Insights article: "Secondary Private Equity – Investment characteristics and market outlook", p. 3

Wespath's Access to PE Secondary Transactions

Wespath believes that the best way to access the secondary PE transactions is through PE FOF managers, which have an established track record of investing in primary PE funds. PE FOF firms have developed long-standing relationships with the majority of the well-known, top-performing primary fund managers. Given the breadth of their portfolios, these PE FOF managers likely already have exposure to many of the underlying companies in the secondary fund interest that is for sale. This provides a competitive advantage to the PE FOF manager by expediting the due diligence process. A faster process allows for a quicker commitment, often a make-or-break factor for a potential secondary interest seller.

Since a primary fund general partner may already have familiarity with an existing PE FOF vendor through a previous relationship, they may be more comfortable admitting that firm into their investor base and, therefore, more willing to approve the transaction. Wespath engaged its existing PE FOF vendor when it committed $50 million to the second JP Morgan Private Equity Group's dedicated secondary fund earlier this year.

Secondary PE fund investing provides a valuable way to supplement an existing primary PE portfolio. It adds diversification across vintage year and manager, and can enhance primary portfolio returns. Given that Wespath has invested with several established PE FOF managers, it is only logical that Wespath should seek to enter the secondary investment universe through these existing relationships.

Wespath provides UMC-affiliated institutional investors with access to well-managed investment programs that historically have delivered competitive performance while honoring United Methodist Social Principles. Wespath is the investments division of the General Board of Pension and Health Benefits of The United Methodist Church, a century-old institution with a well-regarded reputation for delivering returns aligned with values.

Wespath is an established investment manager with approximately $20 billion in assets under management.

Our name honors John Wesley, the founder of Methodism and a leader in establishing social principles that outline the tenets of socially responsible business practices. Wespath reflects this heritage, along with the idea of putting clients on the right path to financial growth with a commitment to values-driven investing.

Wespath

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