The rising tide of secondaries: investors seek private market liquidity

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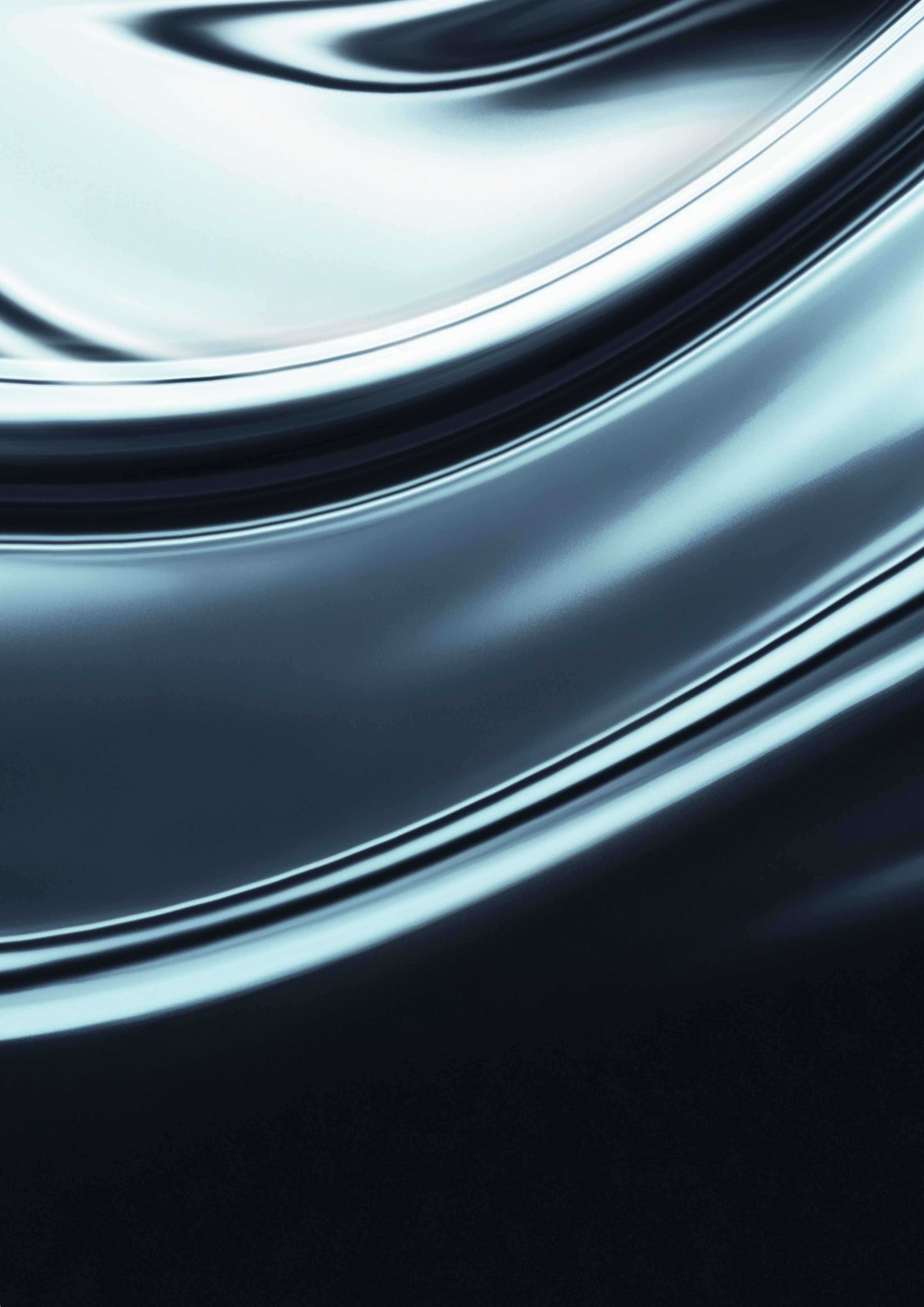
J.P.Morgan



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Introduction

Private markets continue to grow, with holdings in excess of US $10 trillion across private equity, real estate, infrastructure, and credit assets.[1] Yet even as investor interest continues to rise, there's scant liquidity for private assets given their complex structures and limited secondary markets. This illiquidity can be a concern for investors and is often cited as a key barrier to even greater private asset investing.

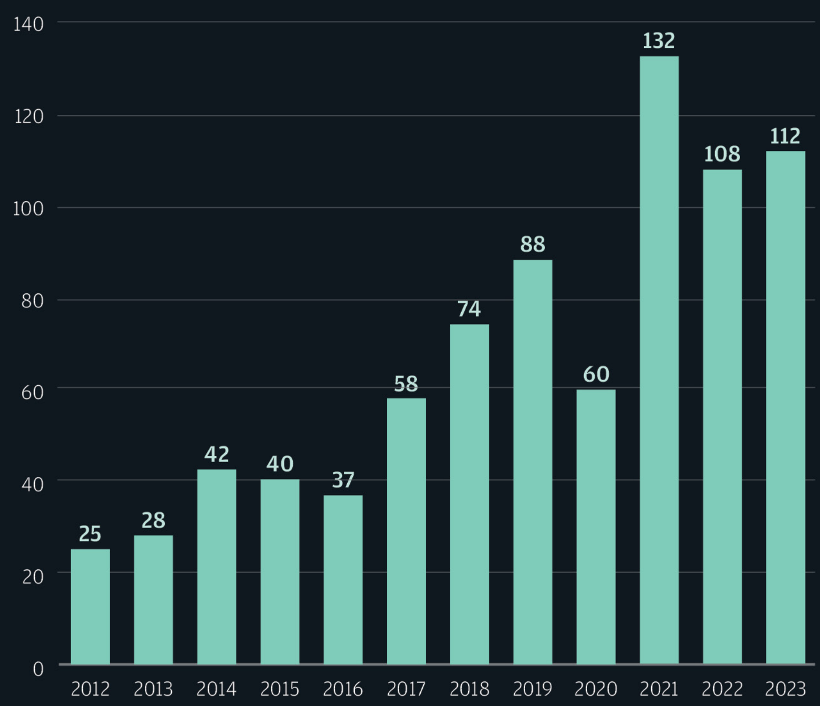
Secondary deals (secondaries) offer a solution to limited liquidity. They provide a way for General Partners (GPs) or Limited Partners (LPs) to sell their existing private investments to another investor in order to rebalance their portfolios, free up capital for other investments, or exit a position due to poor performance. Unsurprisingly, as private investing soars, secondaries are also flourishing.

Following a dip in 2022, secondary deals reached US $112 billion in 2023 with deal volume rising in the latter half of the year as higher valuations brought sellers to the market.[2]

Secondary-focused funds are also on the rise, with ever-larger pools being raised to invest in secondaries. Just in Q1 2024, Lexington Partners closed a US $22.7 billion fund – the largest fund complex ever raised to invest in secondaries. From boutique private equity firms like Banner Ridge Partners to large managers like Apollo Global Management, billions of dollars have been raised and invested in secondary deals and more than 100 funds are still raising capital.[3] That creates a significant amount of highly liquid 'dry powder' available for investment coupled with more favorable valuations that could improve conditions for LP sellers and increase supply.[4]

Secondary market volume

USD billions



1. *Goldman Sachs Asset Management, Oct 31 2023 - Private Secondaries Market: to Liquidity, and Beyond - data sourced from Preqin as of Sept 2023)*
2. *Greenhill, Jefferies, J.P. Morgan Asset Management. "Global Secondary Market Review," Jefferies, January 2024.Data are based on availability as of February 29, 2024.*
3. *Data from Pitchbook, Jan 16 2024- The five largest secondary funds in the market*
4. *Jefferies - H1 2023 Global Secondary Market Review, July 2023*

What's driving growth in secondaries?

"Buyout GPs are sitting on record levels of unsold assets, 28,000 worth US $3.2 trillion. With M&A and IPO exit markets gummed up since the Q2 2022 meltdown, secondary firms like Kline Hill Partners are a more important liquidity source than ever. Our focus on continuation vehicles below US $250 million is an especially important niche for buyout managers as most secondary funds are focusing on much, much larger deals... Some secondary funds offer an especially attractive approach for LPs looking to build alternatives exposure."

Mike Bego
Managing Partner of
Kline Hill Partners

Secondary deals appeal to both GPs and LPs, who have different reasons for selling their stakes.

- With companies staying private for longer and reduced IPO activity, GPs are finding themselves locked into investments for longer periods. They may be looking for ways to exit private investments in order to free up capital for other deals, lock in already-realized gains, source liquidity, or step away from a costly investment. Terms can reach 10+ years and, with rising rates that increase the cost of leverage, some GPs may find it challenging to meet LP distribution expectations.[5] For many, however, the desire to redeploy capital to other investments is paramount.

  With traditional off-ramps less available, secondaries offer a solution to GPs who prefer not to liquidate their assets. Instead, they can have their stake purchased by another investor.

- For LPs, the drivers are different and often reflect the need to rebalance their portfolio, diversify, or source liquidity. Declining equity valuations can create a scenario whereby a portfolio becomes overbalanced in private assets, which are tending to hold their value for longer in current market conditions. Beyond the need to comply with investment allocation guidelines, changes in investment priorities may also create the need to rebalance or diversify into more liquid markets. Alternatively, investors may simply need to exit a position to source necessary liquidity to meet other obligations.

Investors looking to buy secondaries have their own objectives. Secondary deals can give them access to attractive opportunities that are not currently available in the primary market. Investors can use secondaries to reallocate their exposure or gain exposure to desirable market segments. Finally, because sellers are motivated, secondaries are often discounted – giving the buyer immediate value.[6]

Flexibility for sellers (GPs, LPs)

- Portfolio rebalancing
- Access to capital or general liquidity
- Reallocation or diversification

Benefits to buyers (Institutional investors)

- Exposure reallocation
- Access to attractive, otherwise unavailable opportunities
- Often discounted pricing

5. *Ibid*
6. *J.P. Morgan Asset Management, What is the opportunity in the secondary market? Oct 2023*

Not just more deals – more participation

Just as the private markets universe of investors is growing – moving beyond institutional investors to high-net-worth and accredited retail investors – a sea change is also happening in the secondary buyer profile.

Traditionally, pensions and sovereign wealth funds have been the biggest purchasers of secondaries, but the pool is widening to GPs as well as additional LPs. For investors looking to enter or increase their exposure to private markets, secondaries offer a good entry point. This includes family offices, who are among the new investors flocking to secondaries. With registered offerings, secondaries could even open up to high net worth investors.[7]

There are a number of factors attracting these new investors. Private assets are expected to outperform over the next several years, increasing from US $9.3 to US $18.3 trillion AUM by 2027.[8] Secondaries offer diversification, particularly in access to earlier vintages that may no longer be available or different types of assets that are expected to see high growth (such as infrastructure funds that are closed for additional commitments). Finally, these longer-term deals can offer attractive risk-weighted returns and are often available at a discount. At mid-year 2023, the average pricing for LP transactions across all strategies was 84 percent of NAV.[9]

7. *Morgan Stanley - Investing in private equity secondaries, Nov 2022*
8. *From Preqin data as reported in Distributed Ledger Technology and Private Markets, Broadridge, 2023*
9. *Jefferies - H1 2023 Global Secondary Market Review, July 2023*

The challenge? Sourcing... then closing

In public markets, it's easy for supply and demand to meet. That's not the case in private markets, where finding liquidity is a complicated and multi-step process. First, despite the term 'secondaries market', there's no central exchange or marketplace. Second, even if there were, confidentiality is important to both sellers and buyers given the underlying reasons for a sale or purchase. Identifying the opportunity and connecting the parties is the first critical step, but it often requires a knowledgeable and trusted intermediary.

The challenge doesn't end there, however. Once sellers and buyers connect, it can be a multi-step, slow, and highly manual process to structure and close the deal. Intensive negotiations on price and terms are just the start. There are multiple legal documents to agree upon along with rigorous financial reviews, each requiring specialized knowledge. That's why sellers and buyers increasingly turn to expert resources for assistance in negotiating secondaries and structuring deals. Both parties need help – from deal sourcing to diligence to the final transfer – and the seller may also want assistance with portfolio rebalancing and reinvestment.

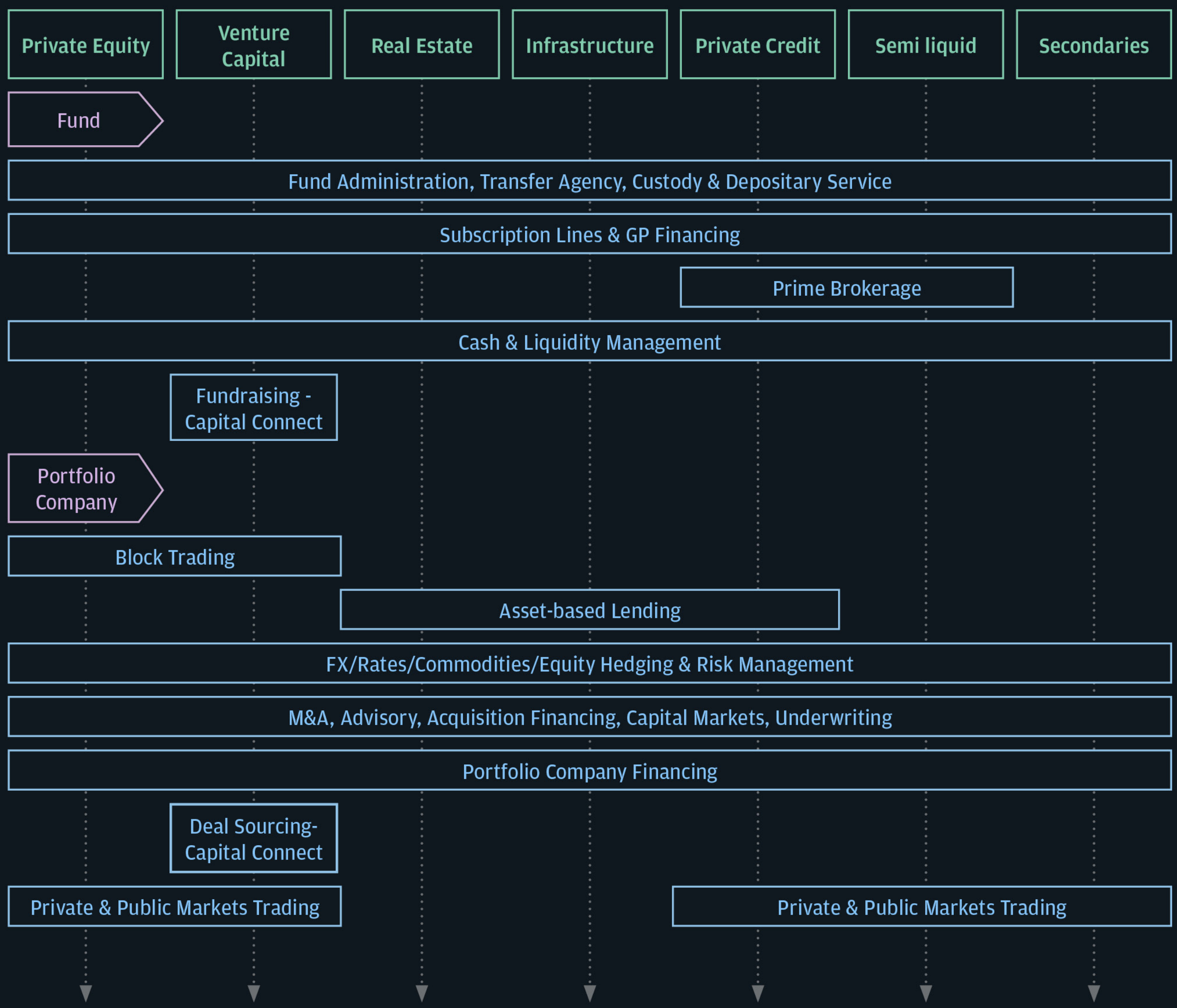
Once the deal closes, intricate fund administration, accounting, and portfolio monitoring require further hands-on guidance from a trusted source.

The challenge?
Sourcing... then closing *(continued)*

The right partner can make a difference. J.P. Morgan brings expertise from its markets, intermediation, structured finance, and securities servicing businesses to help execute secondaries. As a trusted partner to leading alternative asset managers and asset owners, we can provide market color, help source deals, and connect capital. Through every step – diligence, fund administration, portfolio rebalancing, and more – the J.P. Morgan team has the knowledge and solutions to help clients complete these complex transactions and handle their unique operational challenges.

While completing a secondary deal is not easy, getting started is. Contact J.P. Morgan's private markets team to learn what GPs and LPs need to know, and for support at every step of the process.

Global Private Markets: J.P. Morgan Product Reach



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