

# Looking Beyond Private Equity Secondary Markets

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The private equity secondary market is fairly well known to investors but other secondary markets—such as those for hedge funds and private credit—may be less familiar. While smaller, transactions in these markets can still offer compelling returns. With the majority of return coming from realization of discount to net asset value (NAV), these investments can offer important risk mitigation benefits as well. This may be of particular interest today, against a backdrop of quantitative tightening and declining liquidity.

Private equity fund investors seeking to sell interests on the secondary market have been met with robust demand. According to Preqin, the private equity secondary market has grown over five times in the last decade. Today, private equity secondary buyers collectively manage almost \$400 billion with \$141 billion of dry powder.<sup>1</sup> (*Display 1*) This has resulted in high transaction volumes at limited discounts to net asset value for traditional private equity secondaries, serving to bring an element of liquidity to an otherwise illiquid asset.

In contrast, alternative fund investors seeking to sell illiquid assets *not* comprised of private equity have *not* been met with this same level of demand. Despite 2022 being characterized by an almost 40% reduction in secondary transaction volumes, private equity secondaries continued to dominate, accounting

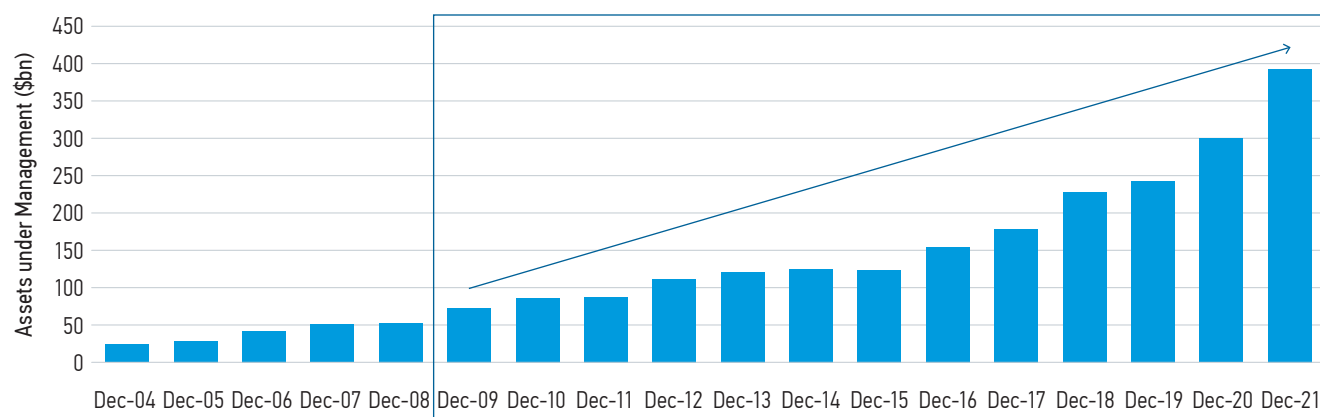
AUTHOR



**JARROD QUIGLEY, CFA**  
Managing Director  
Morgan Stanley  
Investment Management

<sup>1</sup> Preqin Quarterly Update: Private Equity Q2, 2022 data pack

**DISPLAY 1**  
**Private Equity Secondaries Assets Under Management (\$bn)**

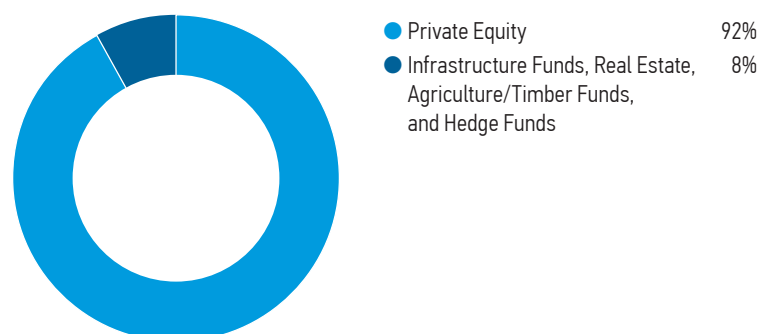


Source: Preqin Quarterly Update: Private Equity Q2, 2022 data pack

for more than 90% of all alternative fund secondaries in 2022,<sup>2</sup> leaving less than 10% in hedge funds, infrastructure, real estate, real asset and private credit funds combined (*Display 2*).

The private equity secondary market is characterized by large intermediaries, transparent processes, cooperative general partners, standardized settlement mechanics and many well-capitalized buyers. In contrast, these favorable conditions are absent for other types of alternative fund secondary markets. We believe this vastly different demand dynamic presents a rich opportunity set for buyers who are willing and able to look beyond private equity and pursue these “undiscovered” secondary markets. Buyers may find they can benefit from less efficient pricing and secure greater discounts to NAV. Compared to private equity secondaries, these higher discounts provide greater downside protection and make the strategy less reliant on growth in asset values and leverage to achieve returns. Below we delve into reasons why the demand dynamic differs—why we think they will persist—and why the dry

**DISPLAY 2**  
**Secondary Volume Across Alternative Asset Classes**



Source: “Volume Report FY 2022”. Setter Capital. February 2023.

powder within the private equity secondary market has not yet reached other alternative asset categories, notably hedge funds and private credit.

**Transaction and Market Size**

The average size of private equity secondary funds raised in 1H 2022 was \$5.8 billion.<sup>3</sup> To efficiently deploy that capital, focusing due diligence on material position sizes and avoiding excessive line items, these

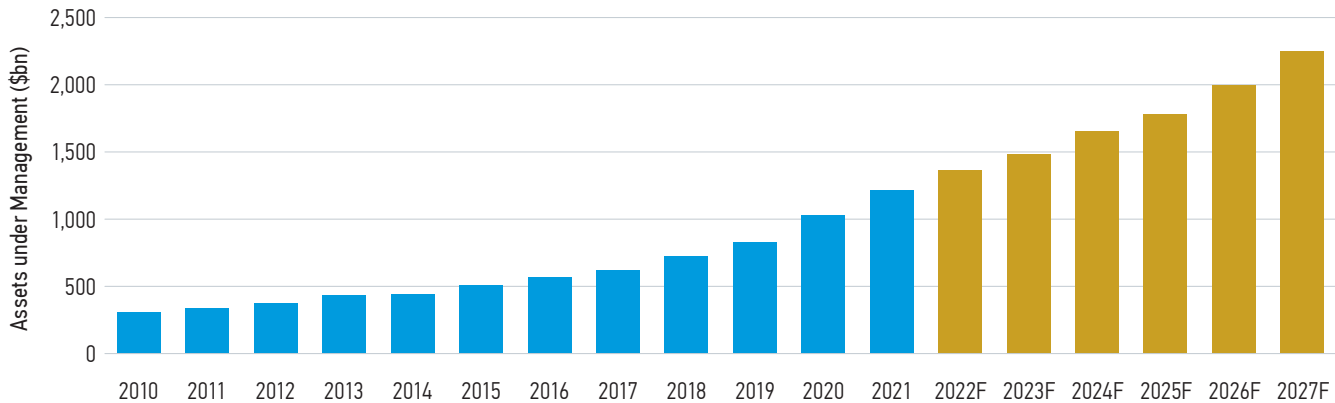
private equity buyers tend to target average transaction sizes exceeding \$100 million. While the total hedge fund market is \$3.8 trillion,<sup>4</sup> the majority of that capital is redeemable at NAV and unlikely to require a secondary sale. When secondary needs do arise in illiquid hedge funds, the transaction size infrequently exceeds \$50 million. Similarly, while private credit assets under management have grown substantially over the last decade, at \$1.4 trillion<sup>5</sup> the

<sup>2</sup> “Volume Report FY 2022”. Setter Capital. February 2023.

<sup>3</sup> Preqin Quarterly Update: Private Equity Q2 2022 data pack

<sup>4</sup> “HFR Global Hedge Fund Industry Report – First Quarter 2023”. Hedge Fund Research Inc. March 2023.

<sup>5</sup> As of December 31, 2022. Bloomberg.

**DISPLAY 3****Private Debt Assets under Management and Forecast, 2010 – 2027\***

Source: 2022 Preqin Global Report 2023: Private Debt Report. December 2022.

industry remains a fraction of the size of the \$5.2 trillion<sup>6</sup> private equity market (*Display 3*). As is the case for hedge funds, this leads to lower transaction volumes and smaller transaction sizes for private credit secondaries. Given private equity secondary players need to traffic in fairly large size transactions to deploy their substantial dry powder, they have largely avoided hedge fund and private credit secondaries which can't supply large scale transactions.

**Asset Class**

By mandate and experience, private equity secondary players focus on funds that contain control private equity positions. Secondaries that arise in other types of alternative funds may include private equity, but typically span several asset classes including credit, litigation, real estate and real assets. Furthermore, the fund manager (or sponsor) may or may not have a control position. Private equity secondary buyers are not apt to traffic outside of their core asset class mandate, leaving these other alternative categories without a natural incumbent buyer.

**Structure**

Private equity fund structures are fairly homogeneous. They are generally closed-ended with a capital deployment

and investment period, a harvest period and extension options. In terms of fee arrangements, they usually charge a management fee and carried interest over a preferred return. Investors typically own a pro-rata portion of all investments in the fund. When secondary opportunities arise in hedge funds, the structures are quite disparate. For instance, illiquidity could be the result of an initial lock-up, a side pocket, a suspension in redemptions or myriad of other reasons. Depending on the structure, hedge fund secondary investors could own a pro-rata portion of the fund or they could own underlying assets in differing portions. Additionally, fee structures are frequently modified and may differ between liquid and illiquid assets. These variables require nuanced due diligence, presenting a barrier to entry for potential buyers unaccustomed to such complexities.

**Relationships and Alignment of Interests**

While there are a small number of asset managers that span alternatives, for the most part the universes of private equity managers and hedge fund managers are distinct. Private equity secondary players tend to have relationships with private equity managers, but little familiarity

with hedge fund managers. Hedge fund managers have no particular incentive to cultivate relationships with private equity secondary buyers. While private equity managers have the incentive to find buyers able to meet unfunded commitments, hedge fund investments are fully funded, and as such hedge fund managers have no particular incentive to cultivate relationships with private equity secondary buyers—particularly buyers unlikely to support growth in the liquid side of their businesses.

**Process and Transparency**

A traditional private equity secondary transaction entails multiple rounds of bids organized by an intermediary with a well-populated data room and access to the sponsor. Once the winning bidder is determined, the closing mechanics are fairly uniform. Financing is typically available to the buyer, if desired. In contrast, buyers and sellers of illiquid funds in other alternative categories are not typically able to engage in the same process. Due to a combination of lack of size, motivation and secondary experience, information is not as readily accessible. Buyers with historical knowledge of the assets and an existing relationship with the asset manager are better-positioned to overcome this barrier to entry.

<sup>6</sup> Preqin Quarterly Update: Private Equity Q1 2023 data pack. April 2022

## Discounts Are Worth the Effort

We believe that secondary investors should expand their focus beyond the well-trodden private equity secondary market. While shifting into undiscovered secondary

markets has challenges, it can be rewarding. For buyers who are able to navigate this more opaque terrain and are willing to deploy less capital per opportunity, the discounts to NAV can be much greater. In a period of declining equity and fixed

income valuations, the greater discount to NAV can provide portfolios with much-needed downside protection, shifting the driver of return toward liquidity provision versus growth in asset prices.

### DEFINITIONS

**HFR1 500 Fund Weighted Composite Index:** global, equal-weighted index of the largest hedge funds that report to the HFR Database which are open to new investments and offer quarterly liquidity or better. The index constituents are classified into Equity Hedge, Event Driven, Macro or Relative Value strategies.

**HFR1 Equity Hedge (Total) Index:** Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

**HFR1 Event-Driven (Total) Index:** Investment Managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

**HFR1 Macro (Total) Index:** Investment Managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposed to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

**HFR1 Relative Value (Total) Index:** Investment Managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. RV position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

**MSCI World Index:** a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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