Secondary Market Trends & Outlook, January 2014

Strong Pricing Drives Record Secondary Market Volume

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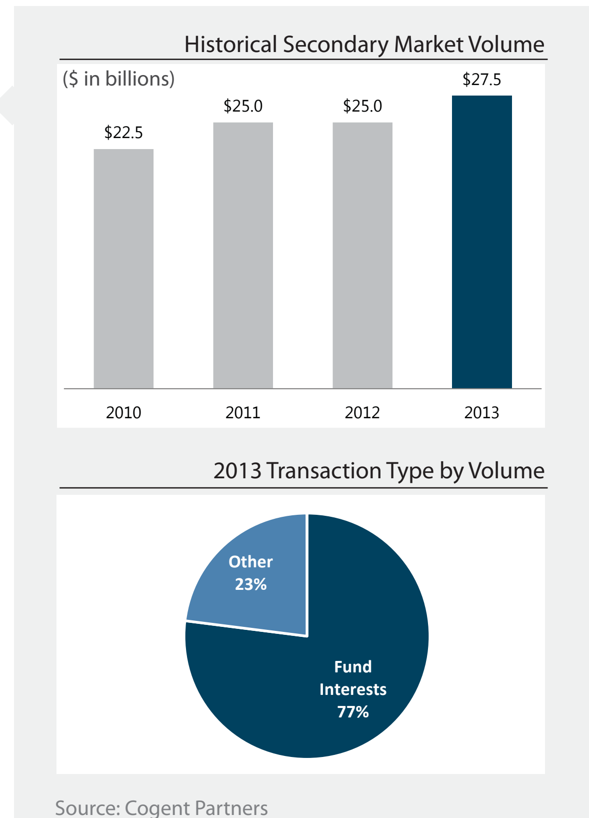
2013 Recap

2013 was a banner year in the secondary market during which both limited partners (LPs) and general partners (GPs) were able to leverage healthy capital markets, strong secondary market pricing conditions and growing buy-side demand to execute transactions ranging from sales of legacy portfolios to complex fund restructurings and spin-outs.

- **A record year for secondary volume…** Secondary market volume rebounded significantly in the second half of 2013, driving annual volume to a new record high of $27.5 billion
- **Pricing rose in 2013 (and continues to rise)…** Driven by strong distribution activity, a nearly 30% increase in public markets and record secondary fundraising, secondary pricing in the second half of 2013 increased for all strategies to 89% of net asset value (NAV) on average, driven by buyout which priced at 92%—the highest levels witnessed since 2007
- **Decline in portfolios of mega buyout funds…** Increased diversity of secondary supply by both fund strategy (e.g. real estate) and more specifically by transaction types; non-traditional secondary transactions—including fund restructurings, secondary directs and spin-outs—collectively accounted for nearly one-quarter of 2013 market volume
- **Seller diversity persists…** While there was significant selling by all types of investors seeking to reduce the number of non-core managers in their portfolios, GPs, financial institutions and public pensions returned to the market in force and accounted for over 75% of secondary volume in 2013

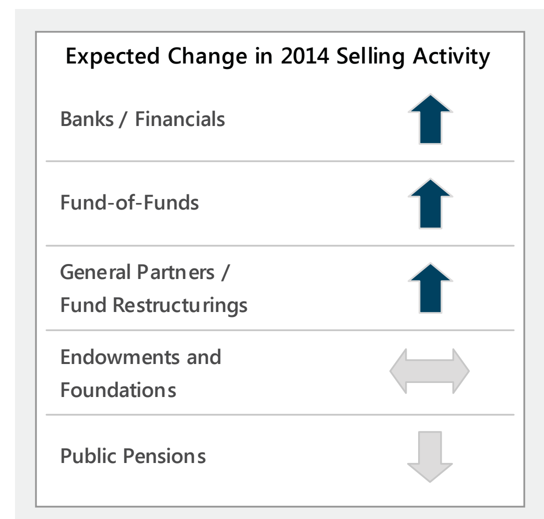


Source: Cogent Partners

2014 Predictions

While 2013 was an excellent year for the private equity secondary market, the year ahead is likely to break new ground. Cogent's expectations for the secondary market in 2014 include:

1. Secondary market volume will experience double digit growth
2. Record dry powder combined with growing appetite for secondaries from traditional LPs will put pressure on buyers' underwriting rates
3. Increasing use of third-party financing will help drive pricing higher
4. Finalization of the Volcker Rule will result in financial institutions being among the largest sellers over the next 12 months
5. Non-traditional secondary transactions—including GP-led restructurings, spin-outs, directs, etc.—will comprise a third of the market volume



Secondary Pricing Driven by Strong Public Markets and Record Distribution Activity

Despite meaningful write-ups in the NAV of many funds throughout 2013, the average high secondary bid for all funds increased to 89% of NAV in 2H 2013, driven in part by steady increases in the public equity markets and record distribution activity for many seasoned institutional portfolios. This increase was once again driven by buyout funds, which achieved average high pricing of 92% in 2H 2013 (Figure 1), eclipsing the 90% threshold for the first time since 2007. Pricing for other strategies remained relatively flat on average, with the exception of real estate which, on average, priced at 86% of NAV.

While overall buyout pricing was 92% of NAV in the second half of the year, this pricing represents a wide range of quality and vintages that were sold in the market. If we examine pricing of large buyout funds that trade frequently, pricing for many such names exceeded 97% of NAV in 2H 2013, compared with pricing for the same names at approximately 93% of NAV in 1H 2013. Therefore, the combination of lower discounts (as a % of NAV) and NAV write-ups between Q4 2012 and Q3 2013 means pricing in dollar terms was up as much as 10% for many funds from 1H 2013 to 2H 2013.

Similarly, venture pricing continued to rise, with average high pricing for venture reaching 80% of NAV in 2H 2013, which was the first time venture pricing has met or exceeded the 80% of NAV threshold in over six years. Just as many limited partners are selectively making new primary venture commitments, buyers of venture secondary interests are increasing. A strong IPO market over the last 18 months has provided liquidity for many aging venture funds that had distributed very little to investors between 2008 and 2011. This demonstration of liquidity, combined with many newer venture-backed investments that have been able to raise capital in multiple successive up-rounds has enabled secondary buyers to be more aggressive on venture assets. That said, there is still significant price disparity across venture funds and managers. While select venture funds are attracting pricing at or above 90% of NAV, there continue to be many funds that price at or below 60% of NAV, as some older funds' portfolio companies face technology obsolescence risk or potential dilution if they are unable to support future financing rounds.

Intuitively, we can expect decreasing secondary market discounts when reported NAVs are deemed undervalued on a mark-to-market basis and/or if there has been an improvement in the future prospects for a given asset or market as a whole subsequent to the reported NAV date. A period of sustained public market appreciation and improving macroeconomic conditions can therefore have a particularly positive impact on pricing and allow sellers to achieve even higher nominal (and real) secondary valuations via well-managed transaction processes. This dynamic was apparent in 2H 2013, as secondary market pricing was propelled by a rally in both US and European public equity markets. Between June 30, 2013 and December 31, 2013, the S&P 500 and STOXX EUR 600 appreciated 15.1% and 15.2%, respectively (Figure 2). Meanwhile,

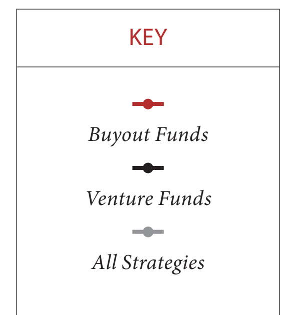
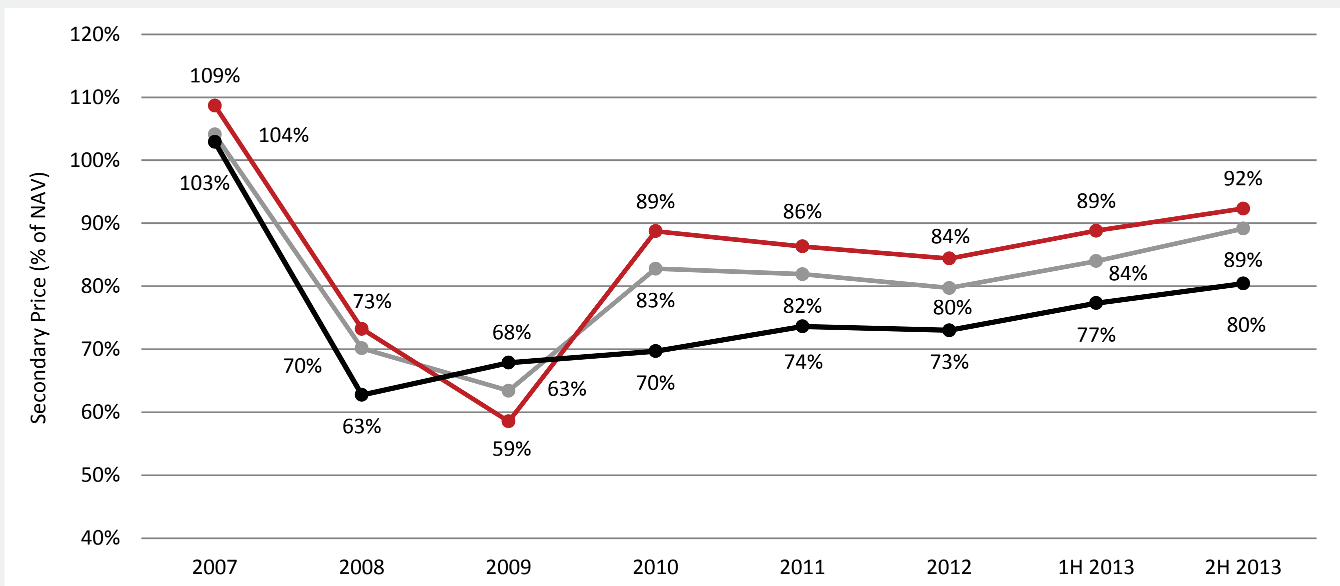
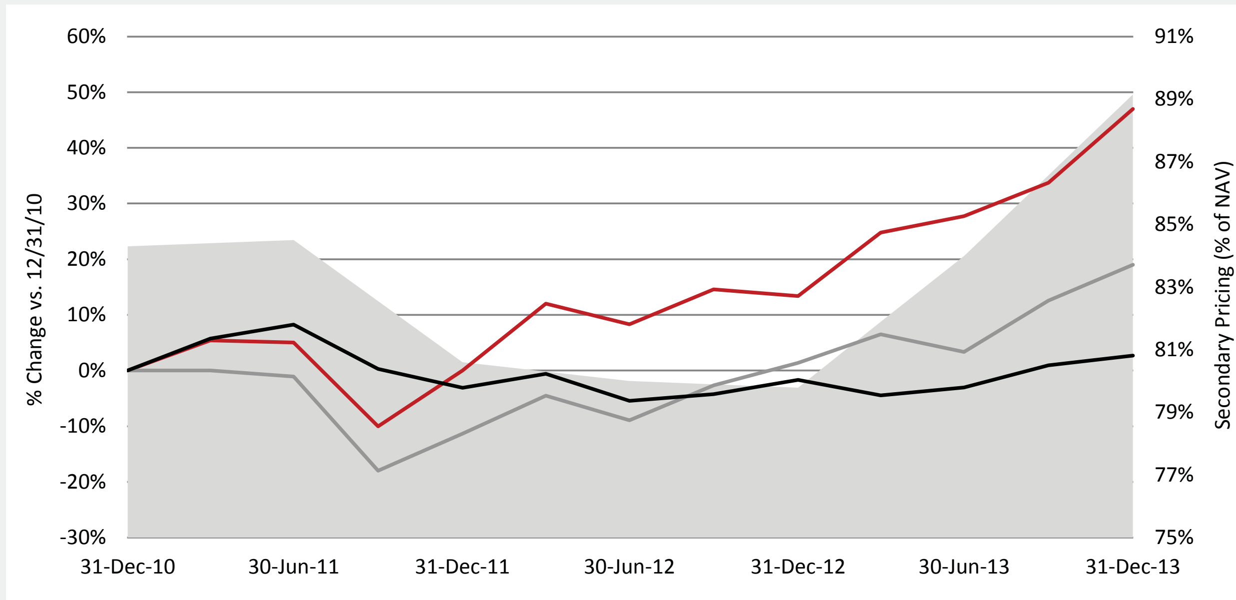


Fig. 1 Secondary Pricing Over Time

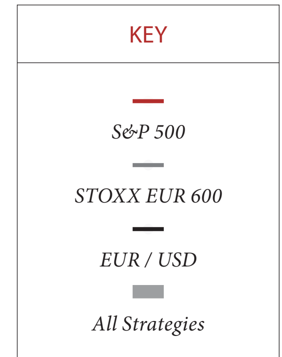


Source: Cogent Partners

Fig. 2 Market Performance Comparison: 2010 - 2013



Source: Cogent Partners



private equity sponsors, taking full advantage of the economic recovery, low interest rates, and favorable equity and debt capital market conditions, made record distributions to limited partners—approximately $60 billion in 2H 2013 and over $120 billion for the entire year, according to estimates from Cambridge Associates.

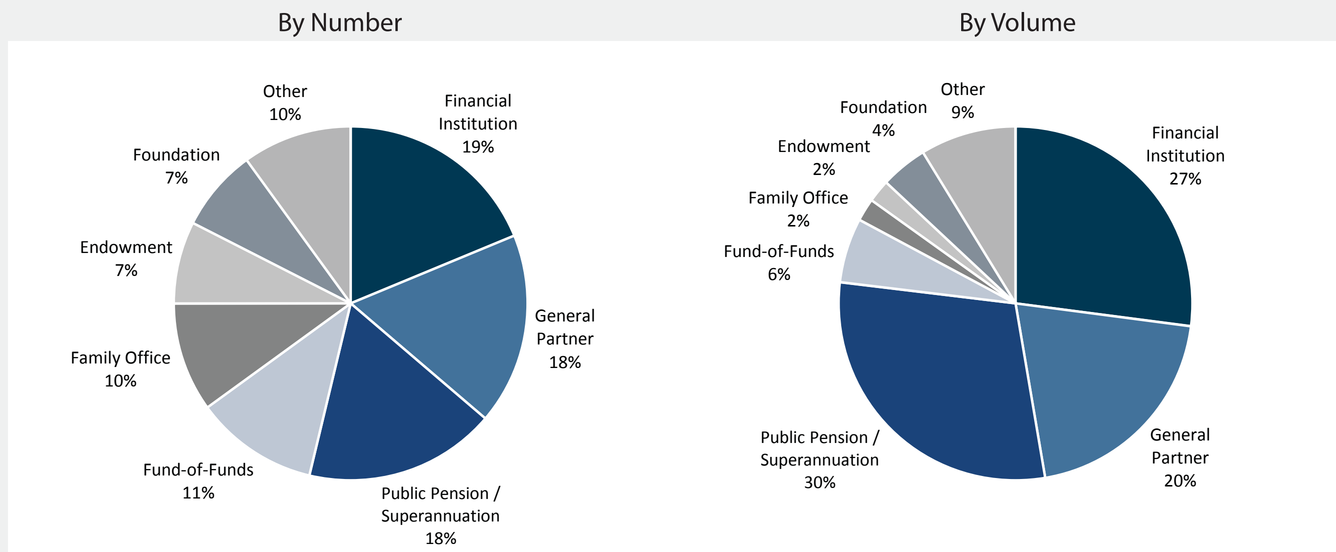
Another factor in the uptick in secondary pricing in 2H 2013 was the fact that the average high bid for real estate funds marketed by Cogent during this period increased meaningfully to 86% of NAV (compared to 81% of NAV in 1H 2013). This follows years of lower pricing (and sporadic volume) driven by overleveraged properties/funds and a challenging recessionary environment following the credit crisis. The outlook for real estate today is decidedly more optimistic. Over the past three years, yields on prime property have fallen below long-term averages in-line with an improving economic landscape, abundant financing opportunities and low interest rates as the Federal Reserve pursued quantitative easing (QE) strategies designed to encourage and maintain economic growth. As the Fed begins the tapering of QE, many real estate investors are increasingly seeking exposure to more opportunistic strategies that offer investors the greatest prospects for outsized performance driven by yield compression. This has prompted new entrants to the real estate secondary market, such as REITs and other institutional real estate investors, that now represent competition for secondary deal flow—a dynamic we expect to continue for the foreseeable future.

Pensions and Financials Return; Fund Restructurings Continue to Redefine the Market

Public pension plans and financial institutions continue to drive a substantial portion of global secondary market volume. In 2013, these two categories of sellers comprised over 35% of secondary sales by number and nearly 57% of secondary activity by dollar volume in aggregate (Figure 3). This dynamic is not surprising in light of the large investment programs (and individual commitment sizes) managed by pensions and financials, as well as the particularly varied set of objectives that has prompted sales by each group over the past several years. The majority of bank sales have been in response to new financial regulations or strategic initiatives such as spin-outs of in-house programs or the divestment of legacy relationships initially intended to drive new banking business. Meanwhile, many pensions, particularly those with inflexible allocation targets, have executed sale processes to address substantial allocation imbalances or to effect major strategic shifts in strategy (e.g. consolidation of relationships, a transition from funds to directs, etc.).

Despite the strong secondary pricing environment, many would-be sellers ultimately chose not to access the market in 2013 given the high level of distributions they received from their alternative asset portfolios. Notwithstanding the liquidity many investors have seen, LPs continue to express a strong desire to reduce the number of GP relationships they manage. For

Fig. 3 — 2013 Seller Type



Source: Cogent Partners

many investors, there is a desire to move to a more concentrated portfolio of managers in which they have high conviction and a desire to support in future fundraises. In order to accomplish this more quickly, many investors are contemplating secondary sales of non-core managers in their portfolio. For investors that did pursue such "clean-up" transactions in 2013, many sellers found that they did not need to include their best assets as sweeteners to achieve strong pricing for their non-core funds. Given the strength of the secondary market pricing environment, combined with institutional investors' continued migration to portfolios of fewer managers, Cogent believes there continues to be pent-up supply of non-core funds that will likely come to market over the next several years.

Secondary market supply in 2013 was remarkably diverse with respect to underlying investment strategy. While over 70% of Cogent's volume was comprised of buyout funds on a weighted/dollar basis, they accounted for only 40% of volume by number. Currently, real estate is beginning to comprise a much larger portion of the market, driven by a narrowing of the bid-ask spread, an increase in buy-side demand and gradually improving fundamentals. Cogent ultimately sold more real estate interests in 2013 than in any prior year—comprising 18% of the funds that Cogent sold in 2013 by number and 16% by dollar volume. Cogent forecasts sustained growth in the market for real asset strategies going forward (including real estate, energy, infrastructure, etc.).

One of the key secondary market trends that continued to take hold in 2013 was the emergence of the GP-sponsored transaction. In aggregate, GPs (including fund-of-fund managers) represented nearly 30% of secondary sellers by number in 2013, and we expect this trend to continue for the foreseeable future. As a result of the financial crisis, many private equity funds and fund-of-funds find themselves in uncharted territory. In many cases, funds are nearing or are already past their original 10-year terms, yet they continue to have material carrying value and often no clear path to near-term liquidity. For funds in which the GP is not expected to receive carried interest, this sometimes contributes to reduced alignment of interest between GP and LPs, and may increase franchise risk for managers that have not raised subsequent funds. As a result, many sponsors are actively pursuing creative secondary transactions that restructure existing vehicles in order to solve a host of timing, liquidity and alignment issues. As one would expect, a large percentage of secondary buyers are pursuing this new source of deal flow after raising record amounts of capital over the past several years. While many market participants project an increase in the number of fund restructurings in the coming years, we believe only a portion of such transactions will be successfully completed. Market participants are demanding a well-managed, full and fair process that produces an outcome viewed as a "win, win, win" for the GP, LPs and new capital sources alike. Secondary market capital is not a simple cure-all for any sponsor that cannot raise a new fund, and given the bespoke nature of these transactions and high potential for conflicts of interest, sophisticated secondary market advisors will play a crucial role in executing the vast majority of these deals.

A Word About Secondary Market Volume

In January 2014, Cogent conducted a survey of the most active secondary market participants in the world—including secondary funds, fund-of-funds and traditional LPs that are actively purchasing secondary interests. In completing our survey of buyers' 2013 transaction volume, we had conversations with each participant and received a 100% response rate. In measuring secondary volume we have always been consistent in using the market definition of volume—purchase price plus unfunded commitments assumed—and our survey methodology in 2014 was no different.

Based on the results of our survey, the transaction volume we advised on in 2013 and our insight into transactions that were completed in the market, we estimate the secondary market transacted $27.5 billion of volume in 2013. With respect to transaction types, traditional sales of interests in funds accounted for approximately $21 billion, while other transactions—including secondary directs, fund restructurings and spin-outs—accounted for the balance. There is significant buyer appetite for these non-traditional transactions and we expect the growth of such transactions will outpace the growth in sales of traditional fund interests in 2014, as buyers seek diversity in their portfolios and face increasing competition for "regular way" fund interests.

Predictions for 2014

1. Secondary market volume will grow by over 10%: The beginning of 2014 is marked by over $52 billion of dedicated dry powder on the buy side, an expanding universe of traditional limited partners pursuing secondary purchases in earnest, a catalyst for fresh selling by financial institutions and a marked increase in transaction diversity in the secondary market. These factors will drive record transaction flow in 2014, with annual volume expected to eclipse $30 billion for the first time.

2. Increasing competition on the buy-side will put pressure on buyers' underwriting rates: Several secondary buyers have recently closed on, or are currently raising, some of the largest funds in history, with fund sizes in some cases likely to exceed $8 billion. Further, many traditional LPs have begun to set annual targets they would like to deploy in secondaries and have established processes and underwriting capabilities in order to bid on a regular basis. With the growth in the active buyer universe both by number and available capital outpacing the growth in transaction volume, many buyers will find themselves under pressure to deploy capital, which could lead them to reduce their target returns.

3. Increasing use of third-party acquisition financing will help boost secondary pricing: An increasing number of secondary market buyers are utilizing third-party acquisition leverage to take advantage of historically low interest rates and increase the nominal purchase price paid to the seller. Prior to 2009, hedge funds and other speciality-lenders offered relatively expensive financing options. This leverage dried up during the credit crisis, but now a growing number of traditional lenders have begun to lend against the private equity asset class. Use of leverage by buyers has had a favorable impact on secondary pricing, as well as served to effectively magnify the level of dry powder available in the market. We expect further buyer adoption of acquisition leverage as competition amongst lenders produces more favorable terms and pricing for borrowers.

4. Final Volcker Rule guidelines will prompt a new wave of bank sales and spin-outs: Following several years of active review, a formal comment period, and redrafting involving bank executives, lobbyists, and the five federal financial services regulatory agencies, the Volcker Rule implementation guidelines were at last finalized in December 2013 (the "Final Rule"). One of the most notable updates included in the Final Rule is the new compliance deadline, which has now been pushed back one year to July 2015. As many banks with meaningful investment programs have taken a "wait and see" approach to initiating compliance of their PE holdings under the Volcker Rule, we project compliance-driven secondary sales will resume now that financial institutions have clarity regarding the ultimate guidelines.

5. Non-traditional secondary transactions will comprise an increased share of the market: As GP led transactions gain greater market presence and acceptance, we believe LPs will play an increasingly important role including increasing pressure on underperforming funds with no imminent liquidity to pursue such a transaction. Given the inherent complexities and heightened potential for conflict, experienced secondary advisors will play an increasingly important role in these transactions to ensure a favorable outcome for all counterparties. Peak-era buyout funds (2005-2008 vintage) have comprised roughly 50-70% of secondary market volume for each of the past five years, and while we anticipate these funds will remain the most commonly traded assets in the secondary market, we expect they will comprise a smaller portion of the market as growth in non-traditional transactions outpaces growth of the overall secondary market. Given this trend, we forecast non-traditional transactions will comprise a third of total volume in 2014.

Cogent Partners has advised institutional investors on more than $77 billion of private equity secondary transactions since the firm's founding. Through its research-driven, analytical approach to the secondary market, Cogent Partners assists institutional investors in achieving their objectives and fulfilling their fiduciary duties.

If you are interested in a confidential discussion of your alternative asset portfolio, including detailed insight into pricing for assets you would consider selling or ideas on other avenues to generate liquidity, please don't hesitate to contact us. All conversations are held in the strictest confidence.

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Should you require a valuation of a specific fund interest, please contact us.

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