North Sky
CAPITAL

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# Investing in Secondaries: The Basics

*There has been tremendous growth in the secondaries market in recent years. Annual secondary transaction volume is now roughly $150 billion—not bad for an investment segment that started around 2007. Secondaries have become part of the investment vernacular and a common component of investors' private markets investment allocations. Yet secondaries are still just a sliver of the overall investment pie—only 3.7% of private capital raised since 2007 was directed to secondary funds according to Pitchbook. Further, dry powder held by secondary funds is estimated to represent less than two years of transaction volume (per Pitchbook).*

## What is a Secondary Investment?

In its simplest form, a secondary transaction is the buying and selling of an ownership interest in a private fund or company for which the seller would otherwise not have a readily accessible redemption or liquidity option. Unlike primary investing, which occurs at a fund's inception or a company's growth stage, secondary investing typically occurs years after the seller made its initial investment. This can mean acquiring interests in a private fund that has already made all of its platform investments and completed its investment period or purchasing shares in a private company that has already scaled its operations.

## Why Invest in a Secondary Fund?

### Benefits of Investing in a Secondary Fund

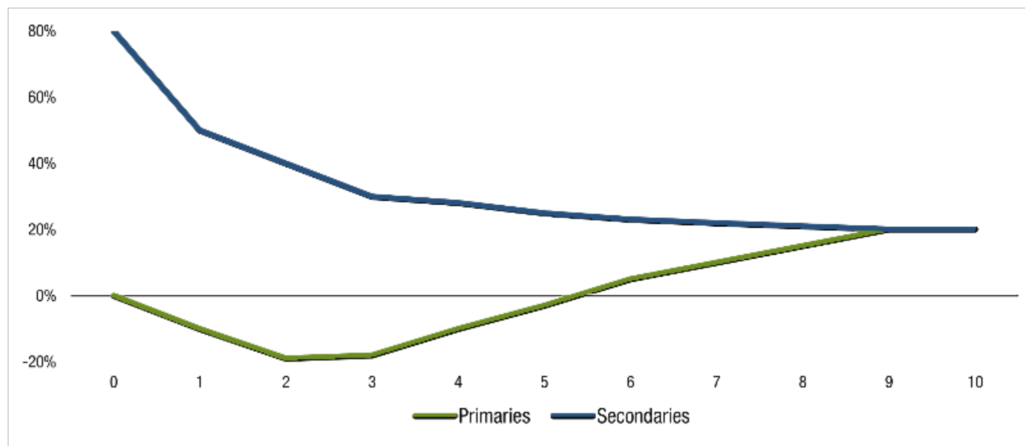
- **Reduced Blind Pool Risk:** Secondaries managers are able to identify and underwrite against the specific assets being acquired as opposed to underwriting a commitment to a newly formed fund in which there is limited to no visibility of what companies will ultimately be included in the fund.
- **Access to Mature Assets**: By stepping into an investment post investment period, there is more clarity on the asset's performance, where future growth is likely to come from and the probability of executing on such opportunity in the future.

- **Attractive Pricing**: Secondary assets are often acquired at a discount to their net asset value ("NAV"), which provides the possibility of higher realized returns due to a lower cost basis. Discounts can vary widely based on strategy, sector, geography and asset/manager quality. Whereas an interest in a buyout fund may command a 5-15% discount to NAV, a venture fund may command a 30-40% discount to NAV.

- **Portfolio Diversification**: An investment in a secondaries fund can provide diversified exposure across an array of key portfolio construction considerations, including asset concentration, geographic dispersion, sector focus, vintage year and growth profiles.

- **J-Curve Mitigation:** Secondaries reduce or avoid the initial negative return period often observed in private investments. The path of the IRR for a secondaries fund over the life of the fund often begins very high and then settles down to a level of the expected outcome for the fund, because secondary funds often buy an asset at a discount to its net asset value and then GAAP accounting rules result in the asset then immediately being written up to its full value. The result is an immediately positive IRR. However, the IRR path for a venture fund or a buyout fund (what is shown as a primary fund in the chart below), the return often goes negative in the early years then turns positive midway through the fund's life cycle. The resulting curve looks somewhat like the letter "J"—hence the term "J-curve." The primary fund's IRR goes negative in the early years due to management fees, operating expenses and, potentially, investment losses. In the later years, growth tends to lead to higher asset valuations. Secondaries funds, in a sense, allow investors to bypass years of negative returns. Institutional investors may make secondary and primary commitments simultaneously such that the secondary investments offset the early negative reported returns from the primary investments, thus smoothing the returns within their private equity commitments.

**Illustrative Net IRR Over Time**




- **Quicker Deployment and Earlier Liquidity**: It is common for venture, buyout and other primary funds to have 4-5 year investment periods and 5+ year hold periods for each portfolio company, resulting in a 12-15 year term overall for the fund. In contrast, secondaries funds often have a truncated 2-3 year investment period and quicker path to liquidity, such as 1-4 years for each portfolio company. The average venture fund returns less than 20% of contributed capital in the first 5 years, while the average secondary fund distributes nearly 50% of contributed capital by year 5, according to Hamilton Lane.

## Sellers and Buyers in a Secondary Transaction

### Secondary Sellers

Sellers such as corporations, institutional investors and fund managers decide to exit private investments for a number of reasons, often involving internal organizational dynamics or due to their views of the future value or desirability of certain assets. Below are some of the more common reasons to sell.

- **Need for Liquidity**. There has been a significant and prolonged downturn in the number of private company exits in recent years (reduced number of IPOs and M&A exits), resulting in a liquidity crunch for private equity investors. Today, the ratio of new private equity investments to private equity distributions is roughly 3:1, when over the long term that ratio should be more balanced. Investors still want to make new commitments where they see opportunity, resulting in sales of private holdings to secondaries funds and the rising use of continuation vehicles to provide an off-ramp to fund investors.
- **Leadership Change**. For institutional investors, a new CIO or lead investment professional often brings different perspective and direction to the portfolio's asset allocation. Repositioning may result in paring investments made by the institution's predecessor to free up capital to invest in alternate initiatives.
- **Conditional Event**. Corporations that have invested in private funds or private companies may seek to sell prior investments typically because (a) the investment objective has been met, such as investing in new companies or funds to learn more about a specific technology or trend that is adjacent to the corporation's business; or (b) the corporation is a public company, and the private holdings delay or complicate the reporting of earnings to shareholders and the quarterly reporting required by regulatory authorities. When a corporation sells, the motivation typically is strategic rather than maximizing the sales price. For family offices and high net worth investors, a death, divorce, bankruptcy, tax or estate planning commonly spurs a sale.
- **Tail-End Assets.** Investors may sell assets that have returned the majority of expected capital distributions, and the investor would rather sell the tail-end of the portfolio now to redeploy the capital elsewhere. Often the dollar amount for each asset is relatively low and the price sensitivity of the seller may be very low, making them willing to sell at deep discounts to eliminate the need to (a) continue to monitor a small investment and (b) deal with tax matters for such assets.
- **New Trend / Opportunity Arises**. Investors may choose to sell existing assets to free up capital for a new opportunity that interests them more.
- **Portfolio Management**. Many large institutional investors may find themselves overdiversified or their investment staff cannot adequately monitor the volume of investments. Selling a portion of the portfolio can reduce it to a more manageable number of funds and GP relationships. Investors may simply want to rebalance their portfolios—e.g., too much growth equity exposure and not enough sustainable infrastructure exposure. Or investors may selectively be culling what they view as underperforming assets or sectors that are no longer viewed as essential to the portfolio strategy.

### Secondary Buyers

Buyers purchase secondary assets mostly because they see an opportunity to achieve an investment return that meets their return expectations and falls within their risk and time horizon parameters. Key factors for buying secondary assets are noted below.

- **Timing Difference**. Secondary buyers often have a 3-5 year time horizon for secondary investments while sellers may desire liquidity now for an investment they have already held for several years. For example, tail-end asset sales allow the seller to offload an investment to a secondary buyer at a steep discount. The seller moves on rather than waiting for a fund to fully wind down, and the buyer wrings the remaining value out of the portfolio.

- **Valuation Perspectives**. Sometimes sellers and buyers simply have differing opinions about the current and/or future value of an asset. For example, the seller believes the asset is going to decline in value, while the buyer thinks it will appreciate in value.
- **Proprietary Knowledge / Sourcing**. Secondary buyers may specialize in an area that give them an edge, such as North Sky's focus on climatech and other impact sectors. Sector expertise provides a more informed view of the future value of assets or where competition is still nascent or lower than in other areas. Such specialization may allow proprietary sourcing of secondary investment opportunities and favorable pricing compared to traditional secondary sectors such as large and mid-sized buyouts. There are approximately 200 secondary firms today, many of them acting as generalists and focused on purchasing LP interests in big buyout funds and related continuation vehicles. In contrast, there arguably only two or three firms focused on climatech today.

## Classifying Secondary Transactions

Secondary transactions are most commonly categorized based on what party is seeking liquidity and acting as the main counterparty in negotiations with the secondary buyer. LP-led transactions are initiated by the owners of the investment (the "LP"), whereas GP-led transactions are initiated by a general partner (the "GP") who manages one or more investments on behalf of multiple limited partners that may be seeking liquidity. Each has unique features and motivations for both buyers and sellers that are discussed below.

### LP-Led Transactions

LP-led transactions involve limited partners, such as pension funds, endowments or family offices, selling their interests in private funds or companies to third-party investors. This is the most common form of secondary transaction and is driven by the LP's desire for liquidity, portfolio rebalancing or a change in investment strategy.

**Key Drivers for Sellers in LP-Led Transactions:**

- **Liquidity Needs**: LPs often need to inorganically generate liquidity to accomplish strategic objectives that are unrelated to a given investment. LPs may sell an interest in a private fund to generate proceeds that can be used to fund new investments or to fund other existing obligations.
- **Portfolio Management**: LPs may find themselves overexposed to certain sectors, geographies or fund managers. LP-led secondaries provide a way to adjust these exposures without waiting for the fund's natural exit points.
- **Market Timing**: Some LPs seek to exit at a time when they believe the fund's future prospects are bleak, valuations may be nearing a peak or secondary buyers are mispricing (i.e., overvaluing) the investment. In this driver, LPs are asserting they can achieve higher returns in other investment opportunities as compared to maintaining its investment in a given fund.
- **Team Bandwidth.** The combination of companies staying private for longer, dry spells in organic liquidity, greater allocations to private markets and more specialized strategies managed by independent sponsors has created an environment where the number of manager relationships an investment team is required to maintain is increasing each year. To manage investment team workload and efficiency, LPs will use the secondary market to cull non-core manager relationships.

**Key Benefits for Buyers in LP-Led Transactions:**

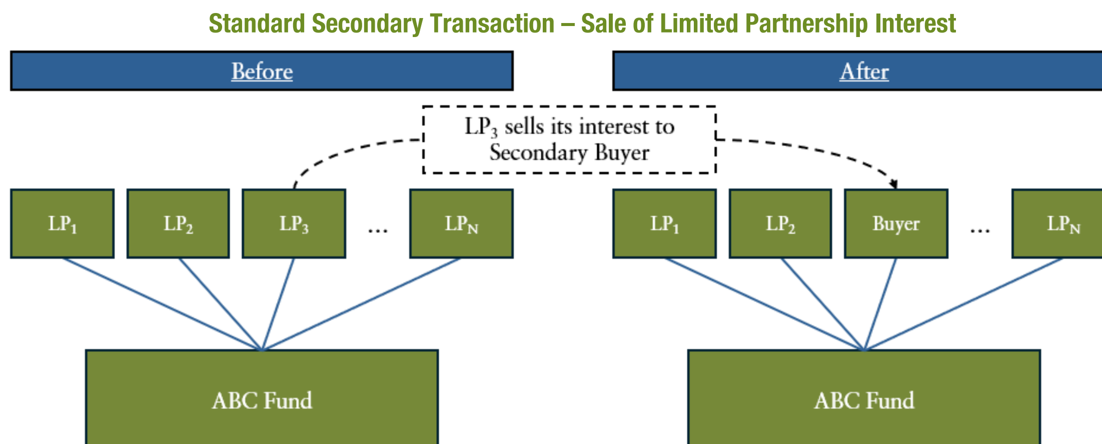
Investing in a secondaries fund that utilizes LP-led transaction structures provides exposure to mature funds or companies with known performance histories, thereby reducing some of the uncertainties that typically accompanies primary investing.

- **Diversification**: LP-led transactions allow you to diversify your portfolio across multiple private funds or companies without having to make individual commitments. This less concentrated approach to portfolio construction provides for diversification across sectors, geographies, stages of development, vintage years and managers.
- **Discounted Pricing**: A number of asset, market and transaction dynamics typically result in situations where secondary buyers can acquire LP interests from sellers at a discount to current NAV. The discount is representative of the illiquidity, exit timing and other risks a buyer assumes and can be a meaningful component to which a secondary buyer generates its return in an investment.
- **Reduced Risk**: By stepping into an investment year(s) after it has been made, secondary investors are able to 1) avoid a period of asset ownership when there were more unknowns and greater risks taken, 2) assess the progress of the manager's original investment thesis and 3) incorporate current information to formulate a forward-looking view on an investment's potential outcomes. This provides a differentiated entry option for investors that are seeking to back a proven strategy and reduce exposure to high-risk ventures.

**Transaction Process and Timeline**

Depending on size, portfolio quality and the buyer universe, LP interests are either directly negotiated between buyer and seller or with the help of an intermediary. Once terms are agreed and documented, the transfer requires approval from the fund's GP, who ensures the buyer meets eligibility criteria and does not disrupt the fund's operations. The transfer has no direct impact on the underlying assets of the fund. The buyer is merely stepping into the shoes of the seller. From start to finish, LP-led secondary processes are typically completed within 90 days of launch.

**Standard Secondary Transaction – Sale of Limited Partnership Interest**



## GP-Led Transactions

GP-led transactions involve the owner or general partner of a private fund seeking liquidity on behalf of its LPs in a manner that allows the GPs to retain oversight of the underlying portfolio companies. Several legal structures can be used to accomplish this, but the most common is a continuation vehicle that involves moving one or more portfolio companies from an existing fund to a new fund. In doing so, LPs in the existing fund are provided with an option to roll their interest into the new fund or sell their interest to a secondary buyer. GP-led transactions began to gain significant transaction post-COVID and today account for 40-55% of annual secondary transaction volume.

**Key Drivers for Sellers GP-Led Transactions:**

- **Preserving Control of High-Performing Assets**: In many cases, GPs want to continue managing high-quality portfolio companies, commonly referred to as "Trophy Assets", that have significant upside potential but require more time or capital to fully realize value. Trophy Assets are typically 2-4 years old and have significantly outpaced the GP's original underwriting expectations.

- **Providing Liquidity to LPs**: Investors have the option to either exit the investment at the negotiated price or roll over their interest into the new fund, giving them flexibility to choose based on their unique circumstances (e.g. investment mandate, portfolio status, or time horizon).

- **Access to New Capital**: GPs can use these transactions to raise fresh capital from new investors, which can be deployed to further grow the underlying portfolio companies.

**Key Benefits for Buyers in GP-Led Transactions:**

- **Deep Asset Knowledge**: GP-led transactions often involve high-performing assets that a GP wishes to continue managing. At this stage, the GP has an intimate knowledge of the asset, its management team, the competitive environment, and the industry. This boots on the ground experience significantly reduces any unforeseen surprises that may have been missed in diligence of a new primary opportunity. This gives secondary investors access to top-tier companies that have already proven their potential.

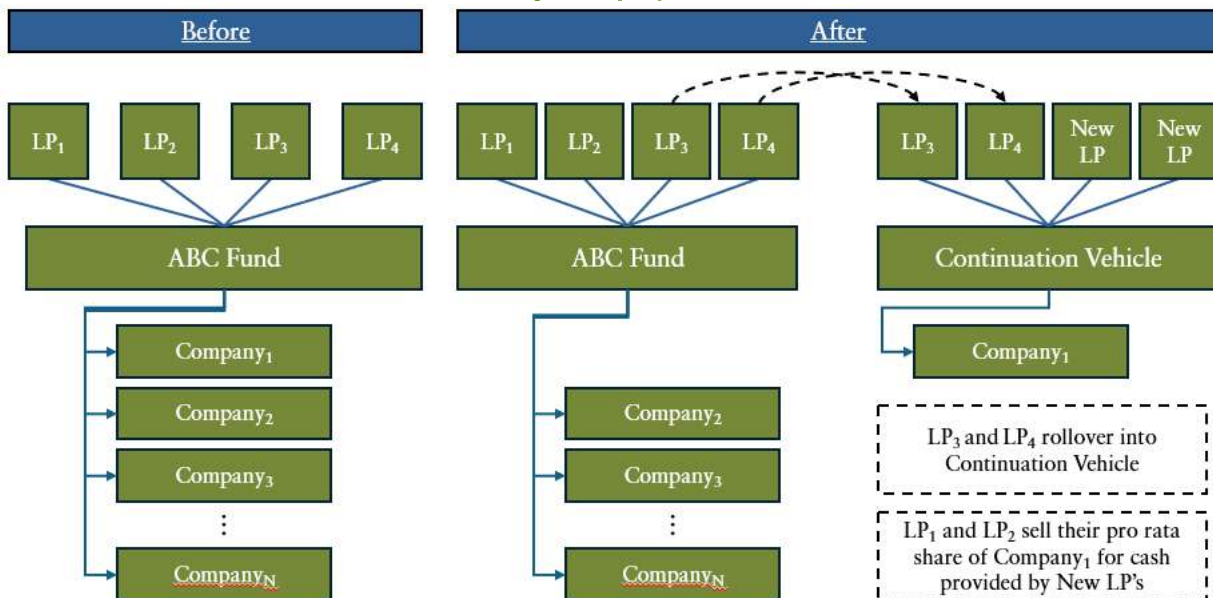
- **Alignment with Management**: In GP-led deals, the GP remains fully aligned with the success of the asset. GPs are typically required to roll 100% of their interest from the existing fund and many times make a new commitment personally or from a more recent fund managed by the GP. Whether it's a single- or multi-asset continuation fund, you are investing alongside a GP who has a vested interest in maximizing the value of the companies they manage.

- **Favorable Terms**: GP-led secondaries often come with terms that are more favorable than those found in primary investments. Specifically, management fees are typically 1% of NAV and carry starts at 10% with a path to 20% assuming certain IRR and cash-on-cash thresholds are met. Other terms such as fund duration and reporting requirements can be refined to enhance the alignment between the GP and the new LP investor base.

**Transaction Process and Timeline**

GP-led transactions are more complicated and take longer than LP-led transactions. As general partners will play a role on both the buying and selling side, the selling fund's LP base, particularly the LP advisory committee, needs to be well informed throughout the process. To do so, investment banks are hired on behalf of the selling fund to manage the bidding process, advise on conflicts of interest and provide fairness opinions. Once terms are agreed to with lead secondary buyer(s), LPs in the selling fund are provided a minimum 20-day election period to make their roll or sell decision. Following the election period, the shares transfer from the selling fund to the new fund with no direct impact on the operations of the underlying asset(s) being acquired. From start to finish, GP-led secondary processes typically take 6-9 months to complete.

**Continuation Vehicle – Single Company Sold to Continuation Vehicle**




## Conclusion

Investing in secondaries can provide a variety of benefits for new and veteran investors alike. If you would like to learn more about North Sky's differentiated approach to secondary investing please contact Tom Jorgensen, Co-head of North Sky's impact secondaries strategy (tjorgensen@northskycapital.com), or Gretchen Postula, Managing Director & Head of Investor Relations (gpostula@northskycapital.com).

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