

The secondary market is currently particularly favourable to sellers and is a very effective portfolio management tool

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Secondary market studies in 2017 published by Greenhill and Credit Suisse (January and May 2018 respectively) report high activity.

Key Points

- Historically high premiums on high quality assets and reduced discounts on riskier assets indicate a **very favourable market for sellers**;
- The high level of available capital ("dry powder") of secondary funds provides the market with **liquidity that feeds transactions on a broader spectrum of assets**;
- Funds of funds and institutional investors have a **very effective portfolio management tool** at their disposal in the **secondary market**.

The main lessons to be learned from 2017

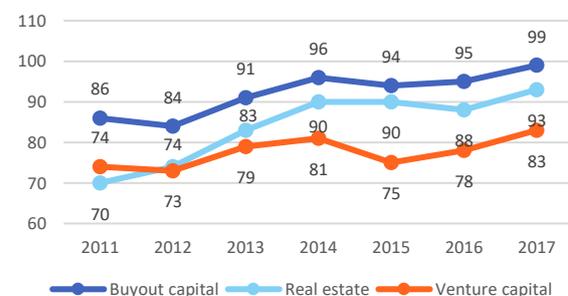
2017 marks a new volume record for the secondary market. The amount of transactions carried out by the participants represented between \$48 billion (according to Credit Suisse) and \$58 billion (according to Greenhill), a level never reached and rising sharply over the previous three years when the market was valued between \$35 billion and \$40 billion.

The market was driven by rising prices and an appetite to invest from secondary funds given a high dry powder, estimated at \$125 billion by Greenhill and \$110 billion by Credit Suisse.

According to Greenhill, prices have further increased to 99% of NAV for private equity funds, 93% of NAV for real estate funds and 83% of NAV for venture capital funds.

The graph below illustrates this trend since 2011.

Graph 1: Price evolution (as a % of NAV)



Source: Greenhill, Secondary market trends & outlook

The price increase is therefore general and benefits both the least risky assets (private equity and real estate funds) and the most risky assets (venture capital funds).

The funds most sought after by buyers are now trading at significant premiums: 20% of recent private equity fund transactions (2012 and later vintages) are traded at more than 110% of NAV.

These two findings, historically high premiums on high-quality assets and significant reductions in discounts on the riskiest assets, illustrate a market that has become very favourable to sellers.

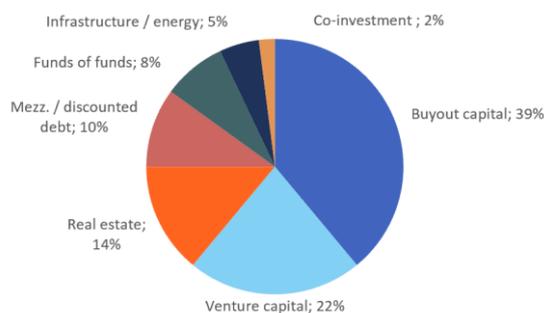
The secondary market is opening up to new asset classes

Secondary funds diversify their spectrum of buying intervention, offering sellers liquidity opportunities on traditionally less sought-after assets.

According to Greenhill, buyout funds (39% of transactions by number), venture capital funds (22%) and real estate funds (14%) continue to represent the main share of assets supplying the secondary market. However, mezzanine / discounted debt and funds of funds are now of interest to buyers and accounted for 10% and 8% of the number of transactions respectively in 2017.

Infrastructure and energy funds accounted for 5% of transactions.

Graph 2: Breakdown by strategy (in %)



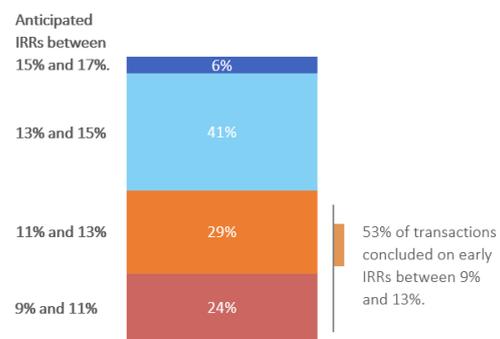
Source: Greenhill, Secondary market trends & outlook

However, Credit Suisse expects the secondary market for infrastructure assets to expand in the coming years, following the momentum of infrastructure fundraising in the primary market.

The secondary market is becoming more and more efficient

The secondary market has become very efficient with prices that secondary funds themselves consider to be good selling prices. In 2017, 8% of assets sold on the secondary market were sold by secondary funds themselves, according to Greenhill.

Graph 3: Breakdown by expected IRR (in %)



Source: Credit Suisse, Secondary market update

According to a survey conducted by Credit Suisse among the most active acquirers in the secondary market, the majority of transactions are underwritten on IRRs between 9% and 13% on an unleveraged basis. **This level of gross return is well below past levels and reflects the strong current buying competition and efficiency of a market that has become highly organized.**

An effective portfolio management tool

The secondary market provides solutions to different types of situations that can be used by institutional investors and fund of funds managers who hold private fund portfolios:

- arbitrage and refocusing of the portfolio on a selection of managers with whom relations will continue;
- sale of high-performance funds lines in order to crystallize the latent performance;
- liquidation of end-of-life fund lines to simplify the administrative and financial management of portfolios;
- solving problems of alignment of interest or investment horizon with funds, in parallel with a process of restructuring the funds concerned.

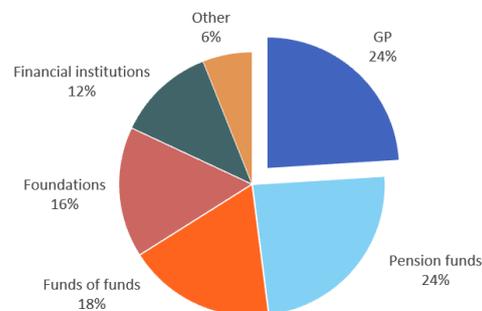
The development of secondary transactions initiated by the managers themselves

The latter type of more complex transaction is usually initiated by a fund manager and a secondary buyer who offer **a partial or total exit solution to historical investors in the fund via a transfer of the portfolio to a new fund**. When the fund is in an underperformance situation, the governance is reviewed as part of the secondary transaction.

These transactions, known as "GP led transactions", can also take place on high-performance funds to offer a liquidity solution to investors who so wish. The manager can thus continue to manage the residual portfolio with a new horizon and benefit from any potential value creation that requires time to be realized.

2017 confirmed the development of these transactions initiated by fund managers. They were already significant in 2015 and 2016 and represent 24% of operations in 2017 according to Greenhill.

Graph 4: Breakdown by seller (in %)



Source: Greenhill, Secondary market trends & outlook

Conclusion

Institutional investors and funds of funds can only welcome the development of the secondary market, which now offers a real liquidity solution.

The depth and sophistication of the market and a particularly favourable economic climate currently allow sellers to sell their assets under excellent conditions.

However, when they are buyers, institutional investors must take into account that the return on secondary transactions will drop significantly in the coming years.

Biography



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Jean-Yves, 56, joined Essling Capital in 2017 after 22 years at Amundi, including as head of the Private Equity fund selection team since 2007.

He began his career with the Sodexo Group, then the Suez Group.

A graduate of ESSEC, Jean-Yves holds a DESCF and a Master's degree in law and is a financial analyst.

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