Preqin Research Report

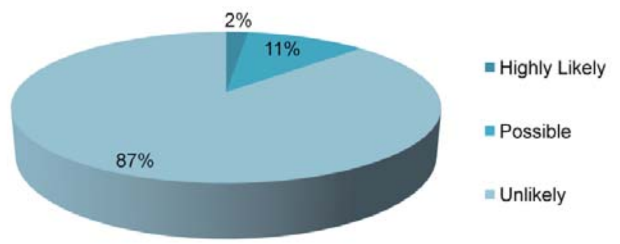
Private Equity Secondaries: The Market in 2010 (1)

Following the onset of the financial crisis, late 2008 and early 2009 saw a number of institutional investment portfolios enter a state of disharmony and distress. With public markets falling, many found themselves over-allocated to private equity as a result of the denominator effect. The expectation felt across the industry was that this would lead to a period of heightened activity on the secondary market, with distressed institutions such as endowment funds being forced to offload private equity interests where they would no longer be able to meet call-up obligations. However, as 2009 unfolded, these expectations failed to materialize in the market.

The Bid to NAV Chasm

As Preqin research conducted at the time revealed, the lack of deal-flow was certainly not due to a shortfall in the number of potential buyers or sellers in the market. A survey of investors showed that 1% were highly likely to be selling fund interests, with a further 9% considering a sale – not especially high numbers, but within the context of a $2.5tn industry, still indicative of a significant level of activity. The market was not short on demand either, with fundraising by secondary specialists at historic highs, and with a number of investors previously focused on primary transactions now considering secondaries activities.

Fig. 1: Likelihood of Institutional Investors Selling Fund Interests on the Secondary Market over the Next 24 Months



Source: *Preqin*

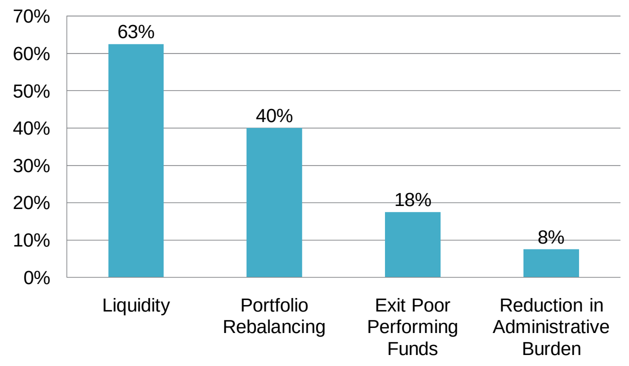
The major factor restricting the flow of activity was the wide gap between bid prices and fund NAVs. As public equities improved dramatically throughout 2009, institutional investors found themselves at a reduced level of distress, and consequently many were less inclined to sell off their private equity investments at such a discount. Private equity fund valuations (running on a delay to public market investments) saw downward adjustments bringing them into alignment with other asset classes, thus alleviating the denominator effects for many investors. With continued uncertainty surrounding the market, neither buyers nor sellers were able to find a centre ground and the market stalled.

2010: A Potentially Record Year?

Although the economic outlook has improved since 2009, there are still a large number of investors seeking to sell fund interests on the secondaries market. As Fig. 1 shows, our latest research indicates that 2% of institutional investors are looking to definitely sell, with a further 11% possibly selling in the next 24 months. This is an increase from last year, due to the lack of activity on the secondary market causing a backlog of potential sellers.

Investors are seeking to exit investments for a number of reasons. Although the denominator effect is now far less pronounced, capital calls far exceeded distributions from existing investments in 2009, and many investors are overcommitted to private equity as a result – especially those with aggressive overcommitment strategies. 63% of sellers state liquidity as a driving factor in wishing to sell. Other important factors include portfolio rebalancing (40%) and exiting poorly performing funds (18%) (Fig. 2).

Fig. 2: Motivations for Selling Fund Interests on the Secondary Market



Source: *Preqin*

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Private Equity Secondaries: The Market in 2010 (2)

The number of potential buyers in the market is also high. While the rest of the private equity market had a torrid time in 2009 in terms of new fundraising, secondaries funds actually had a record year, with 19 vehicles reaching a final close with $23bn raised in total. Goldman Sachs closed a $5.5bn fund in April 2009, which is the biggest dedicated secondaries fund closed to date. Normal institutional investors are also displaying a preference for secondary transactions, with 6% highly likely to buy, and a further 24% of those interviewed indicating an active interest in the market.

With an increase in the number of buyers and sellers, activity in 2010 has the potential to exceed that of 2009. However, activity in the market will again be dictated by the ability of buyers and sellers to reach a consensus on fair pricing.

The Bid Ask Ratio is Closing

Fig. 3 shows the discount / premium to fund NAV for listed private equity vehicle pricing. This acts as an excellent proxy for the level of bids forward by buyers for unlisted vehicles, and is well correlated to the bids being seen on Preqin's Secondary Market Monitor Online marketplace. The graph shows a significant rise in the discount to NAV following the onset of the financial crisis, with an especially big discount increase in the early part of 2009. As discussed, this discount proved too great for many sellers, and prevented the number of transactions from increasing to expected levels.

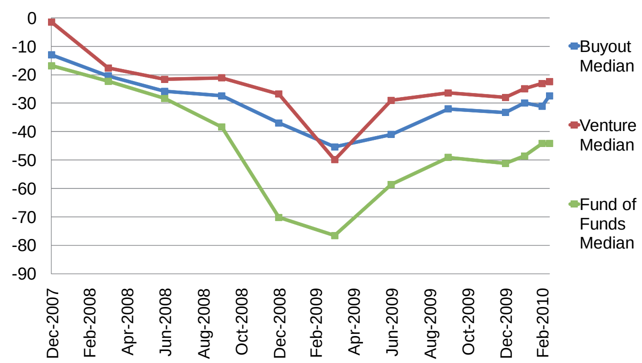
Since mid-2009, prices have been steadily improving, and the market is now sitting at just below a 20% discount to NAV. These levels will prove far more palatable for potential sellers, and as the gap continues to close, the number of sellers that will be willing to exit their investments will rise accordingly.

As a result, sellers are currently enthusiastic about the market, with buyers also optimistic towards secondaries. It appears that a viable equilibrium in terms of supply and demand and pricing is close to being achieved.

Timescale for the Secondaries Boom

This potential is already translating into action - Preqin's Secondary Market Monitor has seen a flurry of activity in recent months, with LPs putting a number of significant portfolios forward for valuation. With secondary transactions requiring plenty of negotiation and time, it will still be some time before the market truly explodes into action, but we are expecting the latter half of 2010 and especially 2011 to exhibit record levels of activity for the secondaries industry.

Fig. 3: Listed Private Equity Discount/Premium by Type



Source: *Preqin*

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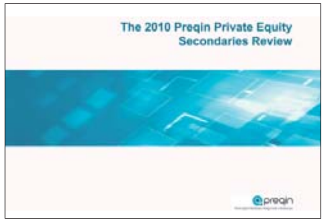

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