Private Market Insights

A NEWSLETTER BY FAST

Getting to Know Private Equity Secondaries

It has been well reported that the opportunity set within public equity markets is not what it used to be. Today, investors with public-only equity exposure are limiting themselves to a highly concentrated fraction of companies in the U.S. economy, as opposed to the broad diversification they seek.[1] As private wealth investors look to diversify their core equity allocation, they have been increasingly turning their attention toward the vast universe of privately held U.S. companies. For investors who are new to private equity, secondaries can be a natural entry point—and a key differentiator for those seeking to complement their existing private equity allocations.

We recently sat down with Nate Walton, Partner, Head of Private Equity Secondaries at Ares Management, to unpack the basics of private equity secondaries.

Q&A with Partner and Head of Private Equity Secondaries, Ares Management

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1. FRED, St. Louis Fed, Wilshire, US Census Bureau, Ares. FRED data current through 2019. All other data as of July 2022.

Q: NATE, CAN YOU TELL US HOW YOU DEFINE PRIVATE EQUITY SECONDARIES AND HOW THEY FIT INTO THE BROADER PRIVATE EQUITY LANDSCAPE?

Private equity secondaries, at their core, represent access to private equity—which is simply equity stakes of private companies. Secondaries serve as a liquidity mechanism for owners of primary private equity investments, as well as an attractive investment opportunity for those interested in diversified exposure to the asset class.

Secondaries provide different solutions that both sellers and buyers need. First, they allow sellers of private equity fund commitments to lock in gains and receive an expedited return of capital. And second, they offer buyers the opportunity to acquire seasoned private equity assets with demonstrated track records, while partaking in the future growth of those assets.

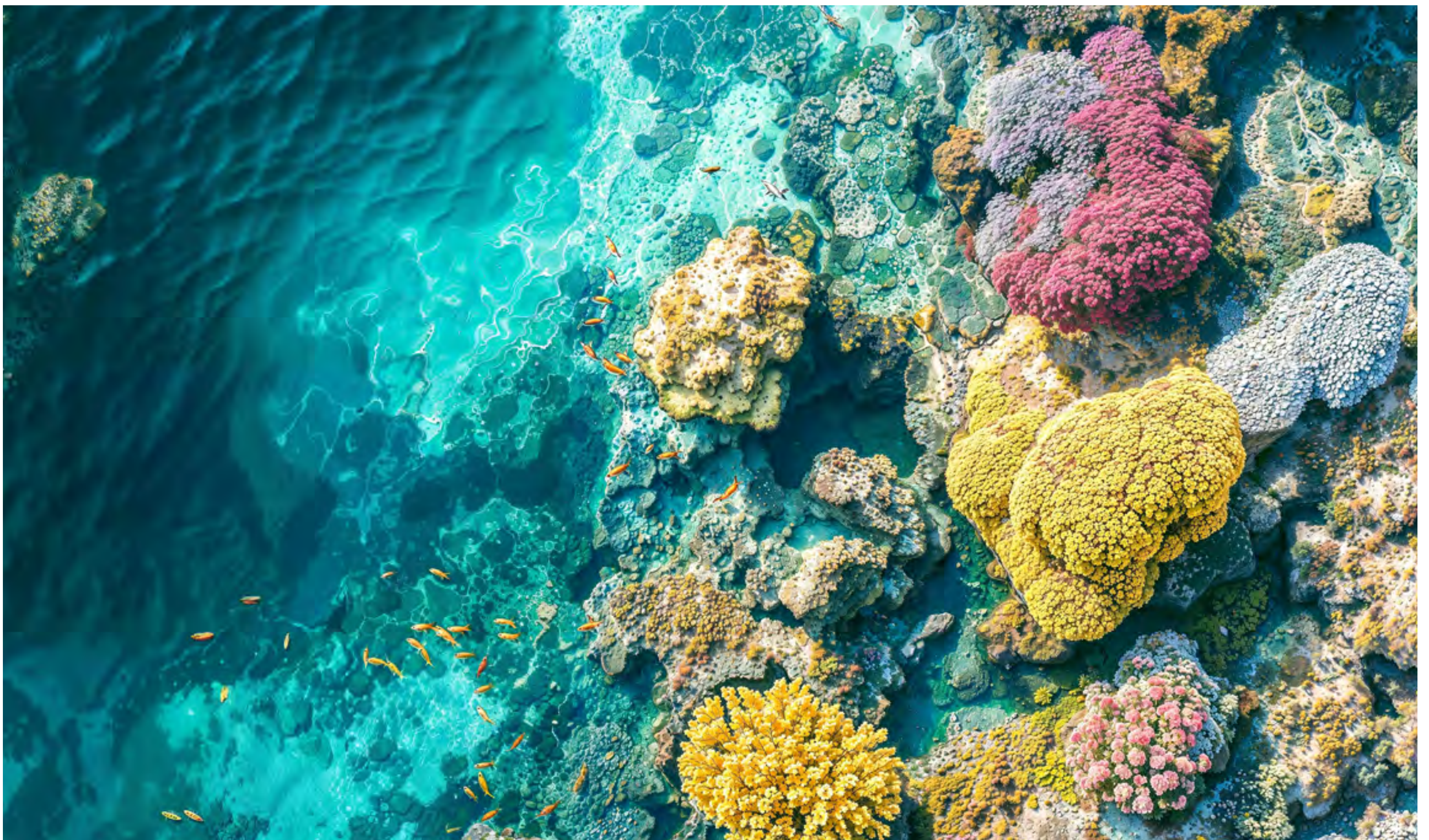
Secondary transactions typically occur in years 6–10 of a primary private equity fund's life cycle.

Q: WHAT ARE THE DIFFERENT TYPES OF SECONDARY TRANSACTIONS?

The two main secondary transaction types are **Limited Partner ("LP-led")** and **General Partner ("GP-led")**. LP-led transactions occur when an investor in a private equity portfolio wishes to sell their ownership to generate liquidity. A buyer of secondaries most often acquires the assets at a discount to net asset value, with the goal of creating a diversified portfolio of private equity assets over time. The sale can range from a single fund to a large portfolio of funds.

In contrast, GP-led transactions are initiated by a GP aiming to distribute capital to investors (LPs) while maintaining ownership of a top-performing asset. The GP will sell the asset(s) into a continuation vehicle[2]—a transaction that gives LPs the optionality to accept liquidity or remain invested.

All parties can benefit in a GP-led transaction. The original LPs (sellers) lock in their gains and get their capital back; a secondary investor (the buyer) can invest in a fast-growing, top-performing asset; and the GP gets to hold the asset for longer.



2. A continuation vehicle is a secondaries structure in which GPs transfer assets from a fund that is at the end of its term into a new fund.

Q: WHAT ARE THE BENEFITS OF INVESTING IN SECONDARIES?

There are three potential benefits to investing in secondaries: **diversification**, **J-curve mitigation**, and **reduction of blind pool risk**. Let's take a look at each of these.

Potential benefits of investing in secondaries

1. **Diversification**
2. **J-curve mitigation**
3. **Reduced blind pool risk**

First, **diversification**. A single investment in a secondary fund typically makes up less than 1% of the overall, versus the 10–15% position sizes in traditional drawdown private equity funds. This broad diversification allows investors to spread risk across different managers, vintage years, geographies and sectors.

The next benefit is **J-curve mitigation**. The J-curve is a well-known phenomenon in the early years of a traditional PE fund's lifecycle, when a manager deploys investor capital. During that period of investment, it is common for returns from purchased companies to be negative and for cash flows to be minimal. But secondary investors, who typically enter later in a fund's life, often avoid this outcome because the assets bought in the underlying portfolio have already been seasoned.

Finally, investing in secondaries comes with **reduction of blind pool risk**. Because assets on the secondary market have typically been in private equity hands for a number of years, there is more historical performance data to inform due diligence. As a result, the GP has a better handle on growth prospects, risks and exit opportunities, and that information can guide a secondary buyer's valuation of the portfolio—potentially resulting in more attractive risk-adjusted returns.

Q: WHAT MAKES SECONDARIES AN INTERESTING INVESTMENT OPPORTUNITY TODAY?

Secondaries continue to benefit from the growing size and need for liquidity in the primary private equity market. The growth of secondary capital to capture this opportunity has led to unprecedented levels of fundraising, but despite a record fundraising year in 2023, the supply of potential transactions is outpacing new capital raised. As a result, we're seeing a supply-demand imbalance that makes the secondary market attractive for both buyers and investors.

In addition to these tailwinds, LPs continue to struggle with slow distributions while GPs are coming up against fund lifetime constraints. The secondary market is an outlet for GPs and LPs to generate the liquidity they need. As GP-led transactions become more popular, investors are gaining access to return profiles in secondaries that are consistent with private equity buyout funds. These returns typically come with lower risk due to the diversification and information advantage that we see with more seasoned assets.

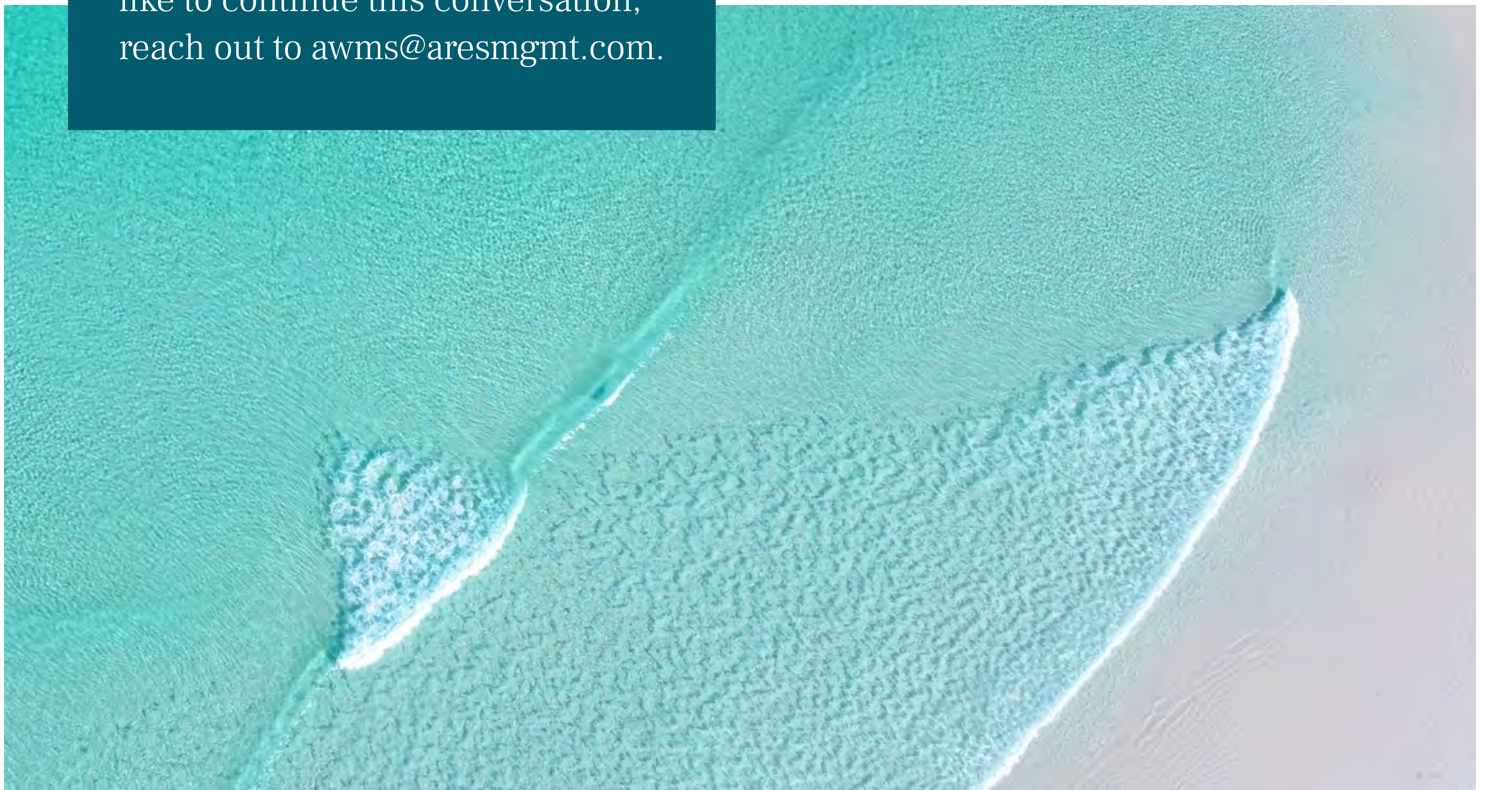
Q: HOW DO YOU THINK ABOUT SECONDARIES FROM A PORTFOLIO ALLOCATION PERSPECTIVE?

With a single fund commitment, secondaries can provide immediate, diversified exposure to private equity. To replicate that level of diversification within a primary portfolio, you'd have to make dozens of investments in a variety of funds—each with their own significant minimums.

So, for an investor who's new to private equity, secondaries can provide a great access point to the market. The diversified nature of secondaries makes for an attractive initial or "core" private equity allocation. And for a more seasoned private equity investor, secondaries can complement a portfolio of existing direct holdings or public equity.

While public equities fueled wealth creation in the past, that opportunity set may be less attractive going forward as high-net-worth investors have more access and optionality in private markets than ever before. **Due to historically lower volatility, broad diversification and access to market-leading managers, private equity secondaries can play a complementary role to public equities and can potentially grow durable wealth over time.**

If you have any questions or would like to continue this conversation, reach out to awms@aresmgmt.com.



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Diversification does not ensure profit or protect against market loss.

There can be no assurance that historical trends will continue.

Investing in private markets involves risk including the loss of principal. Other risks include, but are not limited to illiquidity risk, valuation risks, and a number of other risks related to private companies in general.

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