Unlocking the Power of Private Capital Secondary Markets:

A Guide for First-Time Sellers

PALICO

CONTENTS

1

Foreword

The state of play in secondaries

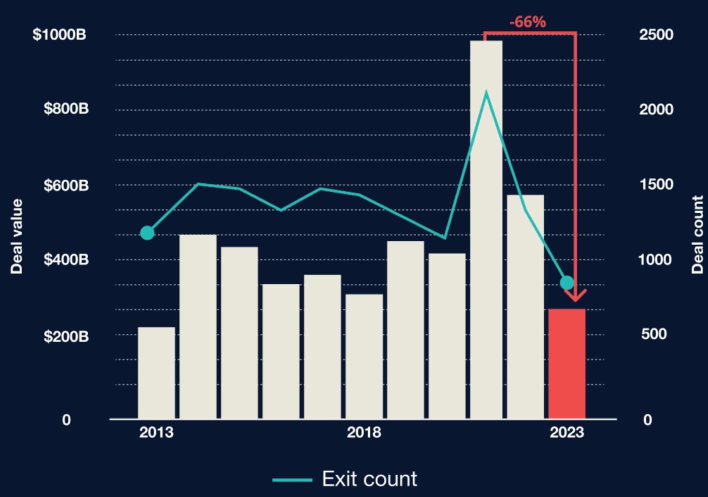
The private equity industry has undergone a remarkable transformation in recent years, with secondaries emerging as one of the most rapidly growing private markets. Limited partners (LPs) increasingly view the secondary market as a vital avenue for actively managing their investments.

This has come into even sharper focus over the past three years of capital market volatility and constrained M&A, which have respectively caused asset allocation imbalances and slowed private equity fund distributions. For example, capital called has exceeded capital distributed by $1.57tn since 2018.

Moreover, private equity firms continue in their attempts to raise fresh funds at a time when exits have slowed. It is estimated that total private equity exit value in 2023 was down by as much as 66% from its 2021 peak.

Exits
Global buyout-backed exit value

Source: Bain Capital Private Equity Outlook 2024: The Liquidity Imperative



Since private capital allocations are largely self-funding—proceeds from existing fund investments are used to commit to new funds on a primary basis—this poses a serious challenge. Thankfully, the secondary market has proven to be a crucial failsafe, allowing LPs to sell their fund stakes and realize liquidity from their investments on their own terms, without being constrained by the traditional long-term lock-up periods associated with private capital investments. With cash flows from funds having fallen, investors are able to crystallize returns and reallocate the proceeds into new funds.

Awareness of the benefits of the secondary market continues to spread, with more and more LPs recognizing the strategic value of actively managing their portfolios through secondary transactions. Interestingly, the secondary market is no longer the exclusive domain of large institutional investors. There has also been a notable recent rise in the participation of first-time sellers—an increasingly broader spectrum of LPs is coming to acknowledge the potential of secondaries to address their unique liquidity needs and investment objectives.

This white paper aims to provide a comprehensive guide for LPs who are new to the market and are exploring the fundamental concepts, benefits, and strategies for effectively capitalizing on secondaries. By demystifying this topic, we hope to empower LPs to make better informed decisions and unlock the full potential of their private capital portfolios.

2

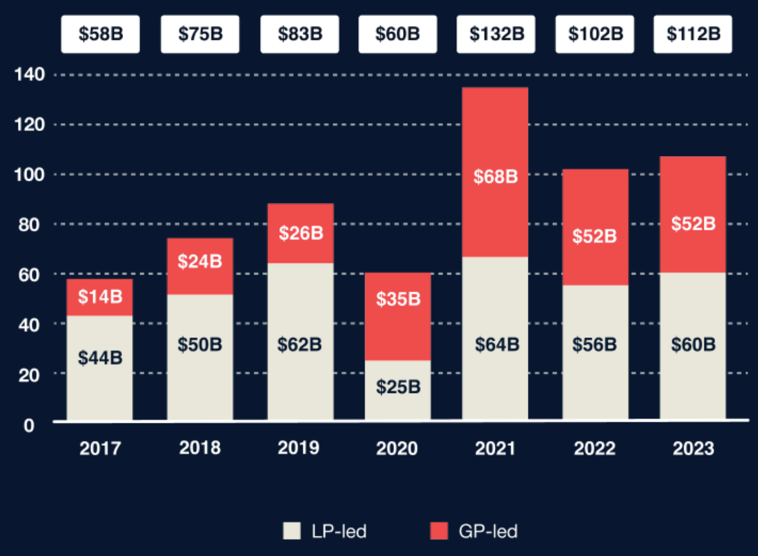
The Fundamentals

of private equity secondary markets

In essence, the secondary market allows private capital investors to buy and sell existing interests in private equity funds. As the market has grown and matured since its early inception in the 1990s, more types of deals have developed to include portfolios of PE fund stakes, providing investors with more liquidity options. This explains why the secondary market has nearly doubled since 2017 to reach $112bn in 2023[1].

Fig.1
Annual Transaction Volume ($B)

Source: Jefferies, Global Secondary Market Review January 2024



There are several key participants in the secondary market, each playing an essential role in facilitating transactions and providing liquidity.

LPs
Investors who commit capital to private equity funds. In the secondary market, LPs can be sellers, seeking to exit their investments early, or buyers, looking to acquire interests in
funds or portfolios.

GPs
The fund managers responsible for investing the capital raised from LPs and managing the fund's portfolio.

Secondary buyers
Investors who acquire interests in private equity funds. These buyers can be specialized secondary funds or institutional investors.

Intermediaries
Investment banks, placement agents and specialist advisors connect buyers and sellers, structure transactions, and provide valuation and due diligence services. They typically earn a commission that is commensurate with the size of the transaction.

Types of secondaries

Today, the market is broadly split into three categories of transactions:

LP-led deals
Also referred to as "traditional secondaries", LP-led deals first gained prominence in the late 1990s and today account for at least half of all deal value in any given year. These transactions involve the sale of an LP's interest in a private equity fund to another investor. These transactions are initiated by the LP and can be motivated by various factors including the need for liquidity, portfolio rebalancing, or a change in investment strategy. LP-led transactions can involve the sale of a single fund interest or a portfolio of multiple fund interests.

Direct secondaries
In a direct secondary transaction an investor directly acquires multiple portfolio companies in a single transaction rather than interests in a private equity fund. These have historically been associated with tail-end funds where GPs seek to wrap up the vehicle by liquidating the remaining assets in a single transaction.

GP-led deals
These transactions are a more recent phenomenon and are initiated by the general partner (GP) of a private equity fund. GP-leds can take various forms such as tender offers, fund restructurings, or stapled secondary transactions, where the sale of LP interests is combined with a primary commitment to a new fund managed by the same GP. In their most common form, the GP seeks to provide liquidity to existing LPs while extending the holding period of certain assets by rolling portfolio companies into a new vehicle called a continuation fund. LPs in the original fund are given the option to cash out their interests or roll them over into the new fund.

For the purposes of this report, we will concentrate on LP-leds since these are initiated by fund investors themselves rather than the GP.

3

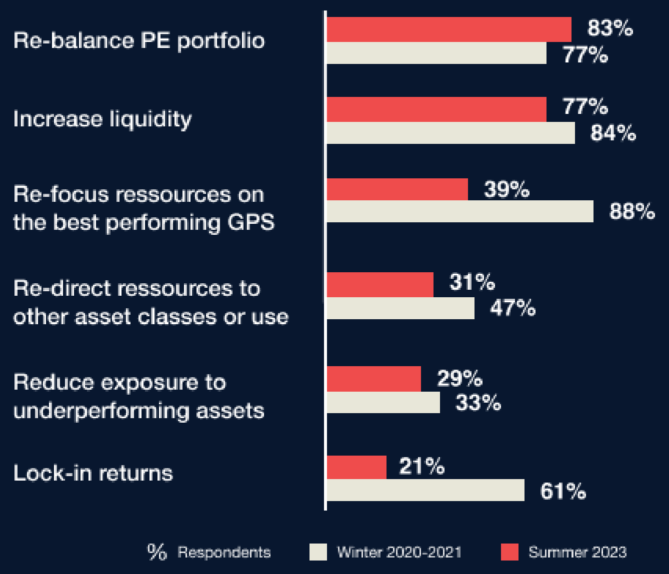
The Benefits

of selling on the secondary market

As more LPs become aware of the benefits offered by the secondary market, its popularity continues to grow. Active portfolio management is at the heart of this market's appeal, 83% of investors last year reporting that this portfolio rebalancing is a reason they sell, followed closely by 77% who say they are motivated by increasing their liquidity[2].

Fig.2
Reasons LPs will sell in the PE secondaries market - next 2 years

Source: Coller Capital Global Private Equity Barometer Summer 2023



LPs use secondary transactions to fine-tune their private equity exposure, aligning their portfolios with evolving investment strategies and market conditions. This flexibility allows investors to adapt to changing economic environments, risk appetites, and investment goals without being constrained by the long-term nature of traditional private equity investments.

As market conditions change and different asset classes or strategies outperform or underperform, an LP's private equity portfolio may become imbalanced. The secondary market allows investors to adjust their exposure by selling interests in overweight areas and potentially reinvesting in underrepresented asset classes, sectors or strategies, thereby maintaining a well-diversified and optimally allocated portfolio.

By selling mature fund interests, investors can free up capital to invest in new funds or strategies that may offer more attractive return potential. This recycling of capital enables LPs to stay at the forefront of market trends and capitalize on emerging opportunities without having to commit additional capital from other sources.

Boosting returns by selling

Private equity investments typically have long holding periods, during which paper gains may accumulate but remain unrealized. By selling fund interests in the secondary market, LPs can convert these unrealized gains into tangible returns, providing a concrete measure of performance.

In fact, selling assets on the secondary market can potentially boost returns. Cash flow optimization and enhancing Internal Rate of Return (IRR) through strategic selling are sophisticated uses of the secondary market that are gaining traction among savvy investors. By carefully timing secondary sales, LPs can manipulate the timing and magnitude of cash flows from their private equity investments. This strategic approach can have a significant impact on IRR.

For example, an LP might choose to sell a fund interest that has experienced rapid value appreciation and delivered distributions in its early years. By realizing these gains and reinvesting the proceeds, the LP can potentially enhance the overall IRR of their private equity portfolio.

IRR is highly sensitive to the timing of cash flows. Selling an interest early realizes a cash flow sooner than if the fund was held until it wound down and distributions occurred naturally. The sooner the cash inflow, the higher the IRR, all else being equal and assuming the sale price is favorable. In this way, even selling a fund position at a discount to net asset value (NAV) can improve performance.

Wider adoption

In the past, secondaries were largely the preserve of large institutional investors using the market to optimize their portfolios. A growing number of smaller LPs and first-time sellers are entering the market, recognizing its potential to address their unique liquidity needs and investment goals

In 2023, 39% of LPs were first-time sellers, up from 25% only two years prior[3]. This trend has also been highlighted by secondary buyers including Ardian[4] and AlpInvest[5] and observed on our own digital secondary marketplace.

For example, in 2024 to date 50% of sellers using Palico are tapping the secondary market for the first time compared with 37% in 2023. We are also seeing more engagement from smaller investors, evidenced by the fact that 45% of sellers on the platform so far this year are family offices, up from 33% last year, and 36% are high-net-worth individuals (HNWIs), more than triple the 11% proportion this investor class represented in 2023.

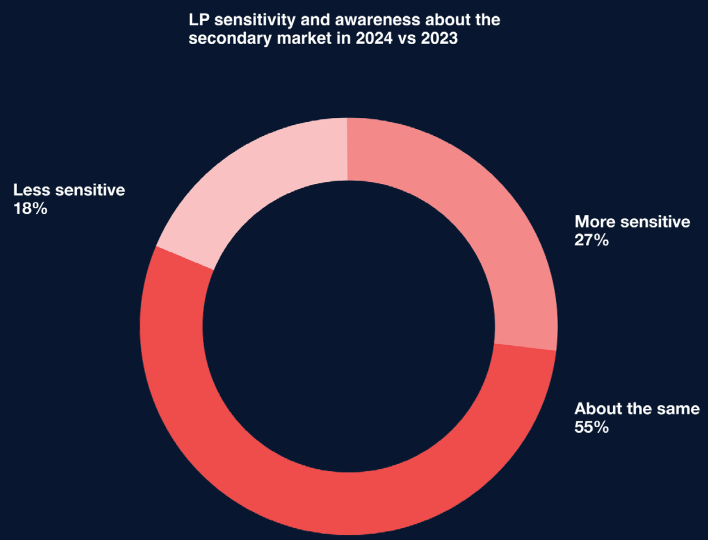
What’s more, 27% of LPs report being more aware of and sensitive to selling in the secondary market this year compared to 2023, while 55% have maintained the same level of awareness and sensitivity[6].

Awareness of the benefits of the secondary market continues to spread, with more and more LPs recognizing the strategic value of actively managing their portfolios through secondary transactions. Interestingly, the secondary market is no longer the exclusive domain of large institutional investors. There has also been a notable recent rise in the participation of first-time sellers—an increasingly broader spectrum of LPs is coming to acknowledge the potential of secondaries to address their unique liquidity needs and investment objectives.

This white paper aims to provide a comprehensive guide for LPs who are new to the market and are exploring the fundamental concepts, benefits, and strategies for effectively capitalizing on secondaries. By demystifying this topic, we hope to empower LPs to make better informed decisions and unlock the full potential of their private capital portfolios.

Fig.3
More than a quarter of LPs are more aware of selling in the secondary market in 2024 compared to last year

Source: Jasmin Capital Secondaries Index June 2024



This rising awareness underscores the growing recognition of the secondary market as a valuable portfolio management tool. The private equity industry's total assets under management (AUM) are projected to continue growing at a compound annual growth rate of around 10% over the next four years to reach $8.5tn in 2028[7], meaning the secondary market will play an ever more important role. LPs who understand and effectively utilize this market can gain a significant advantage in optimizing their investments, maintaining a well-balanced and dynamic portfolio, and even enhancing their time-weighted returns.

4

Traditional
barriers to entry

Several traditional barriers to entry have historically limited participation in secondaries, particularly for smaller investors and those new to the market. These include high transaction costs, complex and time-consuming processes, lack of price transparency, and limited options for holders of smaller fund stakes.

High costs

One of the most significant barriers to entry in the secondary market has been the high costs associated with intermediated transactions. Traditionally, secondary market deals have been facilitated by investment banks and specialist advisors. These intermediaries typically charge fees for their services ranging from 1% to 2% of the transaction value for larger deals, and potentially as high as 3% to 5% for smaller transactions. In addition to success fees, some advisors may require a retainer fee upfront to cover initial expenses and commitment, which also falls on the seller.

These fees can significantly erode the overall returns of a secondary transaction, especially for smaller deals where the fees represent a larger proportion of the total value. For many potential sellers, these costs can make secondary transactions economically unfeasible, effectively pricing them out of the market.

Complex drawn-out processes

The traditional secondary market process is also often lengthy and complex, requiring significant time and resources from both buyers and sellers. A typical transaction can take several months to complete involving multiple stages such as:

1. Preparation of marketing materials and financial information
2. Identification and outreach to potential buyers via an intermediary
3. Due diligence process, which can be extensive and involve reviewing numerous legal and financial documents
4. Negotiation of terms and pricing via an intermediary
5. Legal documentation and closing procedures

This protracted process can be particularly challenging for smaller investors or those with limited resources, who may not have the capacity to dedicate significant time and effort to a secondary transaction.

Price discovery

Another significant barrier has been the lack of transparency in price discovery. Unlike public markets where prices are readily available and transactions are executed instantly, the private nature of secondary transactions has historically made it difficult for participants to gauge fair market prices. Once again, this is especially true in the lower end of the market, where there is less competitive tension and the higher relative commission fees provide less incentive for advisors to find the absolute highest available bids.

This opacity in pricing can lead to information asymmetry, where certain market participants (typically larger, more experienced players) have access to better pricing information than others. This can result in less favorable terms for smaller or less experienced sellers who lack this market intelligence.

Underserved lower-cap market

The commission-based model prevalent secondary market intermediation has created a significant barrier for owners of smaller fund stakes. Most established advisors and intermediaries focus on larger transactions, typically those exceeding $100m in value, as these deals generate more substantial fees.

This focus on larger deals has left a gap in the market. Owners of smaller fund stakes, often ranging from $1m to $20m, have found themselves underserved by the lack of market infrastructure. These investors face challenges in finding buyers for their stakes and often struggle to attract the attention of established intermediaries.

Limited options for smaller stakeholders not only limit their ability to access the benefits of the secondary market but also contribute to market inefficiency. A significant portion of the potential secondary market remains untapped, reducing overall market liquidity and limiting the diversity of available investment opportunities for buyers.

5

The Emergence

of digital secondary marketplaces

The private equity secondaries market is quickly evolving, digital marketplaces emerging to break down many of the traditional barriers to entry that have impeded wider participation. These platforms are disintermediating the market, making it more accessible, efficient, and transparent for a broader range of investors, particularly those with smaller fund stakes or those new to the market.

Lowering barriers to entry

These platforms are streamlining and standardizing what have historically been highly bespoke processes, thereby simplifying the complexities traditionally associated with secondary transactions. Crucially, digital marketplaces have lower minimum transaction sizes compared to traditional intermediaries. This opens up the secondary market to a wider range of investors, including smaller institutions, family offices, and even HNWIs who may have previously been excluded from participating in secondary transactions due to the size of their holdings.

Cost reduction through lower fee model

One of the most significant advantages of digital secondary marketplaces is their ability to drastically reduce transaction costs. Unlike traditional intermediaries that charge higher commissions as a percentage of transaction value, digital platforms operate on a leaner fee model.

This cost reduction is achieved through the efficiencies of technology, which streamlines many aspects of the transaction process, reducing the associated costs of manual intermediation. As a result, sellers can retain a larger portion of their sale proceeds, making secondary transactions more economically viable.

Increased transparency of price discovery

Digital secondary marketplaces are bringing unprecedented transparency to the price discovery process. These platforms use an auction-based model, where sellers can list their fund stakes and receive bids from multiple potential buyers, with no retainer fees and no obligation to sell if their bid targets are not met.

Sellers can see all bids in real-time within a competitive marketplace. This transparency allows sellers to gauge market interest accurately and make informed decisions about whether to proceed with a sale and at what price. Overall, this not only aids in price discovery but improves overall market efficiency and liquidity.

Serving the sale of smaller fund stakes

Digital secondary platforms have opened up new possibilities for owners of smaller fund stakes to access extensive global buyer networks, increasing the potential competitive tension for their assets. These platforms offer two main approaches to facilitate transactions:

1. **Individual stake sales** - Investors can list and sell individual fund stakes, regardless of their size. This opens up the market to a vast number of smaller investors who may hold single stakes in the range of $100,000 to $20m, which are typically too small for traditional intermediaries to handle cost-effectively.

2. **Mosaic transactions** - It is also possible to engage in “mosaic” or aggregated transactions. In this model, sellers can list multiple fund stakes from their portfolio. Buyers then have the flexibility to select individual stakes that align with their investment criteria. Secondary transactions often involve a wider portfolio discount when selling multiple stakes together. In a mosaic, because multiple buyers can select individual stakes, they may be willing to pay closer to or even at NAV for specific assets they want, reducing or eliminating the portfolio discount effect.

6

How to Get Started

selling on Palico

Navigating the secondary market as a first-time or less experienced seller can be daunting. But digital marketplaces like Palico make the process simple, accessible, and efficient. Here's a step-by-step guide to get you started.

Joining the platform

To start selling, LPs can sign up free of charge. The registration process involves proving your status as an accredited investor as defined by the SEC. Once onboarded, you'll gain access to Palico's global buyer network and standardized, streamlined sale process.

Portfolio review & identifying suitable assets for sale

The first step in preparing for a sale is to thoroughly assess your portfolio. Identify which fund stakes are suitable for sale based on your liquidity needs, investment strategy, and market conditions.

Typically, funds managed by GPs with consistent performance are more attractive to buyers. It also pays to follow market developments. For example, recent trends suggest there is stronger buyer appetite for younger funds in the 2015-2019 range[8], with the weighted average vintage being 2016 in 2023 versus 2014 in 2022[9]. This is indicative of buyers seeing younger funds offering more value creation potential. The bottom line is that LPs should analyze their holdings to determine which assets are most likely to deliver the best outcomes.

Reverse secondaries

One of Palico's unique features is its reverse secondary market. In this setup, LPs can review prospective bids from buyers interested in specific fund stakes. This allows investors to gauge demand and indicative pricing for particular funds and strategies before choosing which assets to list.

Listing your fund stakes with no obligation to sell

After joining the platform, assessing your portfolio and exploring buyer interest, you can list your fund stakes. The platform allows LPs to create listings without any obligation to sell, providing flexibility to withdraw if bids do not meet expectations. Listings are anonymous, maintaining confidentiality until sellers choose to engage with interested buyers.

Receiving indicative bids & deciding whether to move forward

Once your stakes are listed, a secure virtual data room is set up for buyers to review necessary documents such as quarterly reports, financial statements, and capital account statements, in order to prepare their bids. To access this data room, buyers have to sign an NDA and the final approval for access remains at your discretion.

Sellers then receive indicative bids through Palico's encrypted messaging system. These non-binding offers help you evaluate market interest and decide whether to move forward with formal negotiations.

Deal execution & transferring ownership

If sellers choose to proceed with a bid, the next steps involve executing the transaction and transferring ownership. This process includes signing a Letter of Intent (LOI), negotiating the terms of the sale and purchase agreement, and obtaining the necessary approvals from the GP.

Palico facilitates these steps through its platform, providing tools to streamline document management and secure communication. The final stage involves completing the legal documentation offline.

7

Conclusion

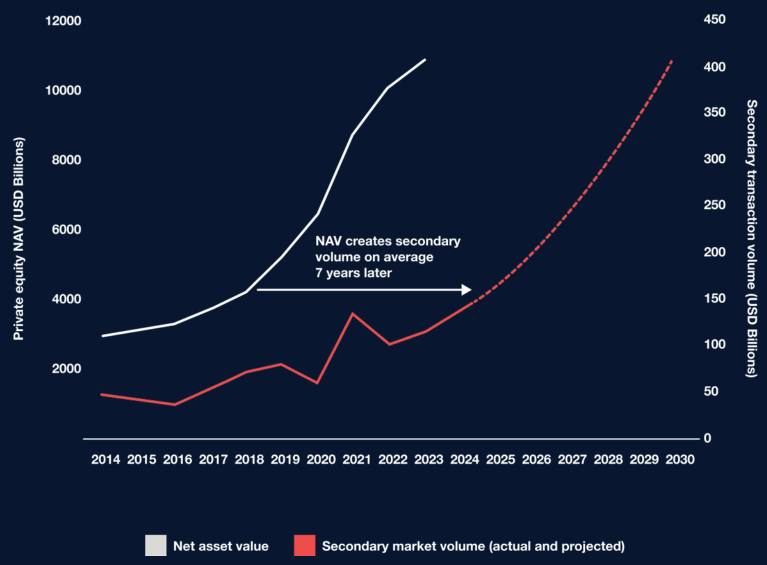
The secondary market finds itself at a critical juncture. The convergence of technological innovation, shifting investor behaviors, and expanding market access promises to deliver an era of unprecedented growth. Standing on the cusp of this new golden age, we leave you with four key predictions that we believe will define the future of the secondary market.

1. The unstoppable rise of secondaries
The secondary market is a powerful tool for sellers, providing LPs with unprecedented flexibility in managing their private equity investments. The benefits are numerous and compelling, ranging from active portfolio management and rebalancing allocations to enhancing IRR.

The rising awareness of these benefits and private equity industry's long-term AUM growth mean the secondary market is poised for explosive growth. It's estimated that annual secondary market volume could nearly triple to $417bn by 2030[10].

Fig.4
Private equity NAV growth signals a ramp-up in secondary transactions

Source: Pinebridge Investments 2024



2. Active is the new passive for LPs
Some of the world's largest asset managers have called for a more active approach to portfolio management across the spectrum of asset classes, as the new monetary policy regime moves to a higher terminal rate than seen post-GFC[11]. This is even more relevant in private equity given the industry's wide returns dispersion[12]. We anticipate a shift in LP behavior from passive holding to greater active portfolio management, investors leveraging secondaries as a strategic tool for rebalancing, optimizing returns, and maintaining a dynamic investment approach.

3. Smaller secondaries claim a greater market share
As digital platforms facilitate smaller secondary transactions, we predict an influx of new, opportunistic buyers entering the market. These may include family offices, smaller institutional investors, and HNWIs seeking exposure to private equity with less blind-pool risk and with the benefits of J-curve compression. The lower barrier to market entry will further improve market liquidity and potentially lead to more efficient pricing for smaller fund stakes.

4. Disintermediation of secondaries accelerates
Digital marketplaces will continue to disintermediate the secondary market, reducing the reliance on traditional intermediaries for many transactions. This shift will lead to greater transparency, lower transaction costs, and improved accessibility for a broader range of market participants. As these platforms evolve, we expect to see enhanced features that further streamline the secondary transaction process and give sellers a clearer view into where the greatest buy-side market demand is, helping them to better manage their portfolios and increase the hit rate of successful sales.

SOURCES

1 Jefferies
Global Secondary Market Review January 2024
https://www.jefferies.com/wp-content/uploads/sites/4/2024/01/Jefferies-Global-Secondary-Market-Review-January-2024_1cb2e6.pdf

2 Coller Capital
Global Private Equity Barometer Summer 2023
https://www.collercapital.com/wp-content/uploads/2023/06/Coller-Capital-Global-Private-Equity-Barometer-Summer-2023-web.pdf

3 Jefferies
Global Secondary Market Review January 2024
https://www.jefferies.com/wp-content/uploads/sites/4/2024/01/Jefferies-Global-Secondary-Market-Review-January-2024_1cb2e6.pdf

4 Ardian
Ardian's Colas on the potential for secondaries growth in 2024
https://www.linkedin.com/posts/palico_podcast-ardians-colas-on-the-potential-activity-7149054290152620032-3svL

5 AlpInvest
AlpInvest: LPs are shopping the 'best parts' of their portfolios
https://www.privateequityinternational.com/alpinvest-lps-are-shopping-the-best-parts-of-their-portfolios-amid-distribution-slowdown/

6 Jasmin Capital
Jasmin Secondaries Index 2024
https://www.jasmincapital.com/wp-content/uploads/2024-Jasmin-Secondaries-Index.pdf

7 Preqin (via Pensions & Investments)
Private equity performance, fundraising lagging but asset growth still expected at 10%
https://www.pionline.com/private-equity/private-equity-performance-fundraising-lagging-asset-growth-still-expected-10-preqin#:~:text=Global%20private%20equity%20total%20assets,Preqin%20private%20equity%20report%20shows.

8 Jasmin Capital
Jasmin Secondaries Index 2024
https://www.jasmincapital.com/wp-content/uploads/2024-Jasmin-Secondaries-Index.pdf

9 Jefferies
Global Secondary Market Review January 2024
https://www.jefferies.com/wp-content/uploads/sites/4/2024/01/Jefferies-Global-Secondary-Market-Review-January-2024_1cb2e6.pdf

10 Pinebridge Investments
Could the Private Equity Secondary Market Triple in Size in the Next Five Years?
https://www.pinebridge.com/en/insights/could-the-private-equity-secondary-market-triple-in-5-years

11 BlackRock
2024 Global Outlook
https://www.blackrock.com/ca/investors/en/literature/market-commentary/bii-2024-global-outlook-ca.pdf

12 Syz Capital
Returns dispersion in Private Equity
https://www.syzcapital.com/en/insights/return-dispersion-private-equity#:~:text=Research%20from%20JP%20Morgan%20(Exhibit,even%20more%20in%20Private%20Equity.

PALICO

https://www.palico.com/