

## EXPERT COMMENTARY

*What seems like a bold prediction at first, may well be a conservative estimate, writes Whitehorse Liquidity Partners managing partner Yann Robard*



## The path to a \$1 trn secondaries market

Over the past 20 years, the secondaries market has experienced significant growth, from a mere \$2 billion in 2001 to \$134 billion in 2021, according to UBS Asset Management. And yet, at Whitehorse Liquidity Partners, we believe a range of forces are poised to significantly accelerate the scale and impact of the secondaries market even further over the next decade. We predict that the secondaries market can grow to more than \$1 trillion by 2030.

### Where the market has been

The genesis of the secondaries market can be traced back to the early 2000s when it was just a cottage industry providing liquidity to distressed investors.

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Over the years, institutional allocations to private equity grew, and so did the need for liquidity within the asset class.

Initially, that liquidity was required during periods of volatility to right size allocation during public market declines. However, over time, private equity investors increasingly tapped the secondaries market to actively manage their private equity portfolios. It has been well documented that the secondaries market has experienced explosive growth. In just six short years, Evercore

reports that the secondaries market has more than tripled in size, up from \$37 billion in 2016. The 'why' behind this growth is important to unpack.

First, the growth of private assets in has far outpaced that of public markets. Private equity NAV has grown by 14 times between 2000 and 2020, while public market NAV has grown just four times over that same time period, according to McKinsey. Over a similar time period (2000-2019), McKinsey reports that the number of public companies is down approximately 40 percent, while the number of US sponsor-backed companies has increased by 60 percent between 2010 and 2019. Public markets are shrinking, and

private equity is growing.

Second, an inherent problem with private markets is their illiquidity. As increasing institutional capital has been directed to private assets, the secondaries market has grown in parallel. The growth and increasing sophistication of the secondaries market helps to mitigate the illiquidity issue. LPs are becoming more thoughtful and strategic regarding how they manage their portfolios. GPs are utilizing the secondaries market as a means to retain ownership of high conviction portfolio companies and are increasingly sophisticated in their management company oversight.

Herein lies the importance of the secondaries market – it provides liquidity to an otherwise illiquid asset class.

### Where we are now

The secondaries market is at an interesting inflection point. As we enter 2022, it is evident that many LPs are struggling with their private equity allocations. Investors have been victims of their own success. Private equity has performed well over the past two decades. In fact, McKinsey reports that 2021 was a banner year for private equity. However, the majority of this performance can be attributed to growth in valuation as opposed to liquidity, leaving investors overexposed to the asset class. Distributions over the course of 2021 were in-line with previous years, yet LPs' unrealized portfolios increased rapidly, McKinsey reports.

This has led to investors being over-allocated to private equity ahead of what is expected to be a record fund-raising market in 2022. We are seeing GPs come back to market faster and with larger funds. Based on McKinsey's research on the 20 fastest growing fundraisers, the average flagship fund size more than doubled to over \$10 billion between 2017 and 2021. At the same time, the period between fundraises has been cut nearly in half, shortening to 35 months over the past five years relative to 60 months for the previous five. Those same fundraisers have

also broadened their product offerings over the same time, with the number of funds offered per GP having grown from 1.7 to 2.3 products, on average.

LPs are generally looking to re-up with existing relationships, support their long-term GP partners as they embark on new strategies, and commit to new managers, but are struggling to find the allocation and liquidity to do so. Volatility in the first half of 2022 has only compounded this issue further as LPs tread cautiously with deployment against a backdrop of uncertainty in the market and unclear liquidity prospects.

The secondaries market can enable LPs to actively manage their exposure and tactically reallocate through all market environments. GPs can increasingly turn to the secondaries market as a means to generate liquidity for their LPs through continuation funds, while retaining ownership of prized portfolio companies for the next growth stage.

### Where we are going

LPs accessing the secondaries market to manage over-allocation is just one use case. Secondaries market volume has also benefited from the rapid rise in GP-led transactions over the past three years in particular. In fact, GP-led transactions represented more than half of the volume in 2021, according to Preqin. We believe a number of factors will support the secondaries market's growth well in excess of 2021's record volume to over \$1 trillion by 2030.

We believe the core drivers are simple and twofold. First is the broader growth of the private capital market. Since 2016, the global private capital market has nearly doubled, growing by an average of approximately \$1 trillion annually from \$5 trillion in 2016 to nearly \$10 trillion in 2020, according to Preqin. According to Preqin, the latest estimate sits at approximately \$12 trillion in Q3 2021. This equates to 15-20 percent growth per year. Assuming a more muted go-forward growth rate of 10 percent, the broader private capital market could reach over \$15 trillion by

2025 and \$25 trillion by 2030.

The second driver is the growth of the churn rate in private capital assets. Since 2016, data from Evercore and Preqin suggests that the annual volume of the secondaries market has represented roughly 1 percent of private capital assets under management. We believe that churn rate could grow to 4 percent by 2030 for several reasons.

#### 1. Increasing sophistication of LPs.

For public market investors, rebalancing a portfolio is a common occurrence. However, private market investors have historically maintained a commit and hold strategy. We have begun to see LPs proactively managing exposure to private assets and they are often using the secondaries market to do so. Over the next decade, as institutional investors grow their private equity programs, we anticipate they will require even more active management and will evolve from a commit and hold strategy to a commit and actively manage strategy. The secondaries market can enable this.

#### 2. The rise of GP-led transactions.

There has been a proliferation in GP-led single and multi-asset continuation funds in recent years. In fact, these transactions represented 51 percent of 2021 secondaries market deal volume, according to Preqin. GPs have awakened to the fact that through continuation funds, they are not beholden to realizing their portfolio companies after a typical three- to six-year hold period. They can give their LPs the option, but not the obligation for liquidity and/or maintaining ownership of select assets. We believe that 10 years from now, a GP that is not using GP-led transactions as a tool will be left behind, similar to how operational value-add evolved over the past 10 years.

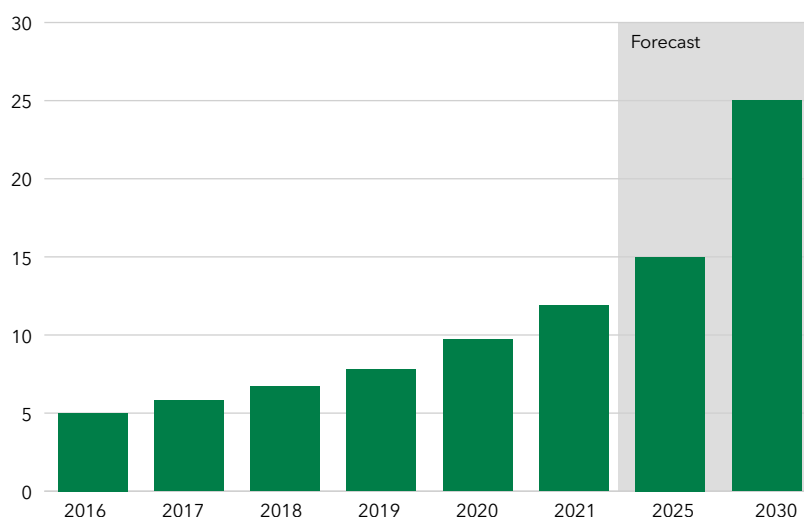
#### 3. Blurring lines of GP stakes and secondaries.

Private equity GPs are seeing themselves not merely as fund managers but as sophisticated

asset managers with significant inherent value in their management companies. As GPs look inwards at their own companies, they are becoming more strategic in how they manage their firms and balance sheets. We believe the next decade will give rise to GPs becoming even more thoughtful about how they manage their management companies, plan for new partner succession and grow their balance sheets to support GP commitments. But we also anticipate the trend of consolidation between asset managers to continue. GP stakes themselves could start to be bought and sold to other GP stakes investors, like financial sponsors have bought and sold companies to one another.

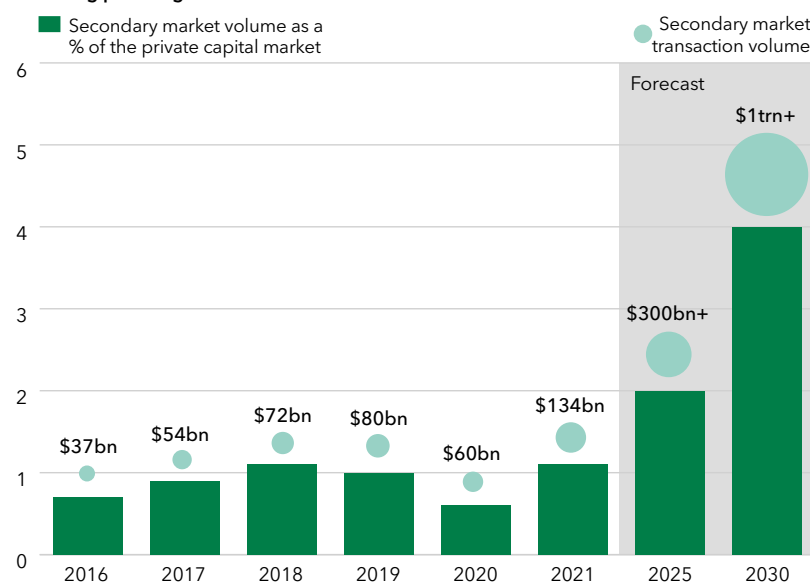
4. **Emergence of high-net-worth investors.** There is expected to be a rise in demand for alternative investments from high-net-worth individuals. At the beginning of 2022, only about 9 percent of GPs have a dedicated retail-oriented vehicle, but a 2020 Prequin report concluded that over a third of GPs anticipate having a retail-oriented fund within five years. Individual investors will need more liquidity, not less.
5. **Maturation of other private asset classes.** In recent years, other private asset classes such as real estate, infrastructure and private credit have continued to mature. Bain reported in 2021 that real estate and infrastructure funds raised 17 percent and 30 percent more capital than their respective five-year average. As these other asset classes continue to evolve and the underlying portfolios mature, there will be an opportunity for more secondaries market activity. This will be particularly relevant for strategies like real estate and infrastructure, which have longer hold periods.
6. **Constant innovation and disruptive change.** Above all, we anticipate continued innovation in the

Global private capital AUM (\$trn) has grown...



Source: Prequin as of March 31, 2022; 2021 data as of September 30

...enabling parallel growth in the secondaries market



Source: Prequin as of March 31, 2022; 2021 data as of September 30, 2021; Evercore Secondary Market Survey, January 2022

secondaries market. We are in the early innings of alternatives such as preferred equity or other structures that provide liquidity with innovative and flexible terms. The evolution of new strategies will provide more tools to allow investors to generate liquidity on their private equity portfolios and meet their objectives. In many ways, the secondaries market is the “Google” of private equity, creating new financial technology to provide investors

liquidity in an otherwise illiquid asset class.

When disaggregated this way, what seems to be a bold prediction is more digestible. A private market that continues to grow at a more muted rate than historical to \$25 trillion. And an increase in the percentage churn of private capital assets on an annual basis from 1 percent to 4 percent. Together, these lead to a potential \$1 trillion secondaries market by 2030. We believe this is just the beginning. ■