Jumping the J-Curve

April 2017

DeMarche

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Abstract

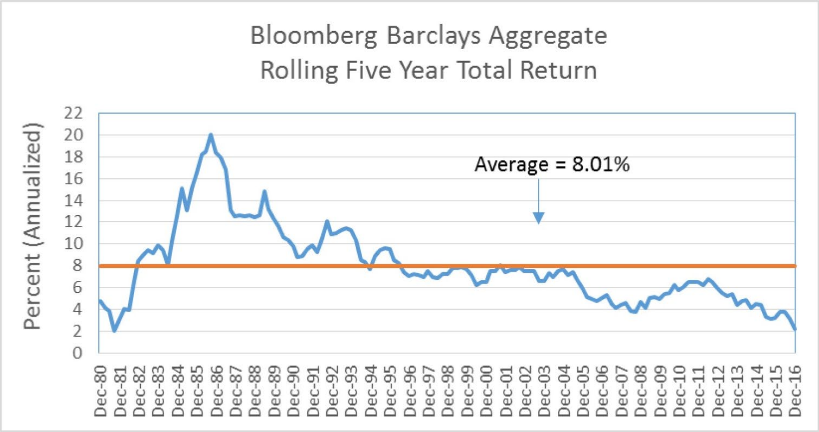
This paper outlines how secondary private market investments can serve as an important portfolio management tool and J-Curve mitigant due to the fact that secondaries are often acquired at a discount to NAV and in many cases are already proving distributions to investors, thus improving the cash flow profile of the overall private market portfolio

J-Curve Definition

In private equity, the J Curve represents the tendency of private equity funds to post negative returns due to initial investment commitments and management fees during the investment period with the expectation of and then realizing increasing returns in later years when the investments are harvested.

Background

With the great financial crisis of 2007-2009 and resulting intervention to support markets on the part of the Federal Reserve now appearing more distant in the rearview mirror, investors are confronted with a somewhat harsh reality as it relates to their portfolios. As DeMarche has forecast for several years, the secular bull market for fixed income, driven by declining interest rates, is effectively over. This is best illustrated in the table below, which tracks rolling five-year returns for the Bloomberg Barclays Aggregate Index since 1980.



Bloomberg Barclays Aggregate Rolling Five Year Total Return

This development has led many of our clients to evaluate their existing asset mix, as a conventional 60/40 allocation between equities and fixed income was not only inefficient from a portfolio construction perspective, but is increasingly less likely to generate sufficient returns. More broadly, asset classes that were once considered peripheral in nature have acquired significance as the macro environment continues to change. As a result, DeMarche has helped drive broad adoption of private market solutions (both private equity and real estate) across the majority of (non-defined contribution) client portfolios.

On an annual basis, a standing committee of experienced DeMarche consultants meet in early January to discuss capital market conditions and expectations for returns and attendant risk across over 30 asset classes, most of which have client exposure. These expectations are incorporated into our modeling, and, combined with an understanding of client risk tolerance and objectives, become the basis for asset mix and/or asset liability studies conducted on behalf of our clients throughout the following year. This is important because the model typically likes the risk and return profile of private equity, as well as real estate. The limitation of the model is that it does not factor in illiquidity, which for some clients is a legitimate concern and may be a precluding factor in the adoption of private market asset classes.

The risk and reward profile of both private equity and real estate is typically well understood by most institutional investors, because, like most assets, the variables are income, appreciation, and return of capital. With broader acceptance and wider adoption of these asset classes, new investment opportunities in secondary markets have become available. The remainder of this paper will be devoted to defining and discussing the emerging asset class of private market secondaries.

What Are Secondaries, Exactly?

Investing in secondary transactions can be traced back over 30 years, while the first secondary fund was formally launched in 1988. Secondaries occur when partnership stakes change hands when investors who had previously agreed to invest and provide capital for a decade (or more) decide to sell their economic interest early. The purchasing entity owns the future economics of the investment, which sometimes includes future capital call obligations. Investors may acquire secondary interests in a variety of ways, including single position purchases, portfolios, structured transactions (typically recapitalizing an existing partnership), “fund of fund” interests, and via direct investment. Secondary investment opportunities are accessible across the entire private equity spectrum (venture capital through mezzanine), as well as real estate and infrastructure.

Why Do Private Market Investors Sell to Secondary Buyers?

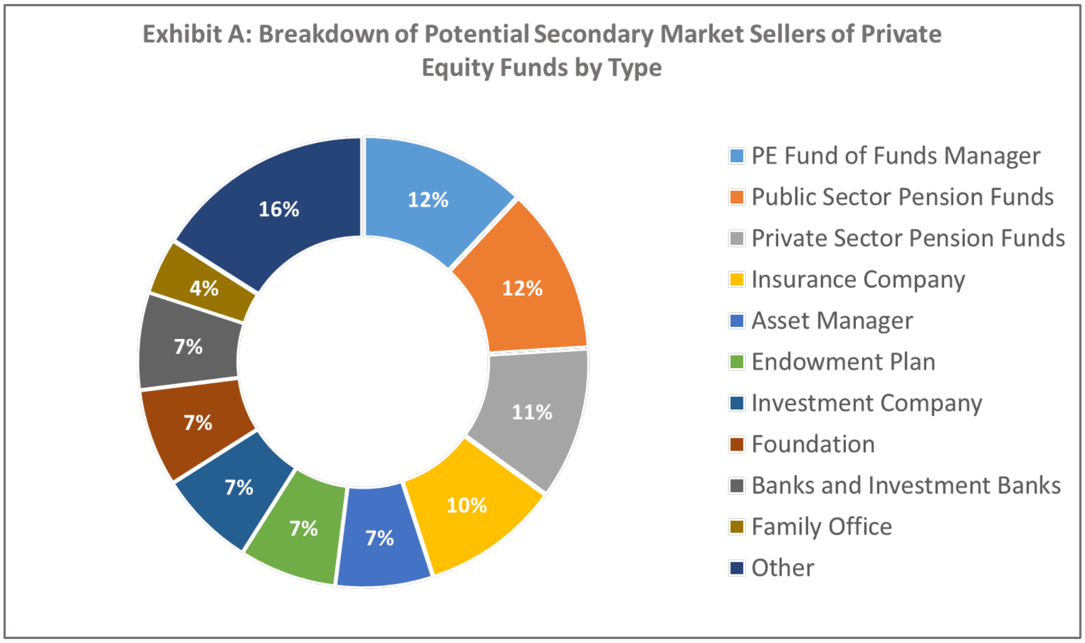


Exhibit A: Breakdown of Potential Secondary Market Sellers of Private Equity Funds by Type

There is no one reason or scenario that creates selling situations. In some cases, a plan sponsor will sell interests that are no longer strategically aligned with their broader investment objectives. Occasionally, a limited partner will sell their partnership interest as they desire to avoid future capital calls. A limited partner may also become a seller to address broader portfolio allocation changes. During the great financial crisis, numerous partnership interests changed hands as the need for liquidity forced distressed sellers to monetize private partnerships. Finally, regulatory considerations play a part in creating the secondary marketplace, including Basel III, Volcker Rule, and Solvency II (to name just a few), as financial institutions and related entities are presently precluded from holding as much in Level II and Level III assets on their balance sheets. (Please refer to Exhibit A above for a graph pertaining to seller profiles.)

Who Are the Buyers

Once largely the domain of well-connected buyers, sellers, and intermediaries, the buyer profile has significantly changed and is becoming more diversified, with pension plans (both public and private) and endowments and foundations representing more than one-half of the buyers in a recent Preqin report. Please refer to Exhibit B (below) for additional detail.

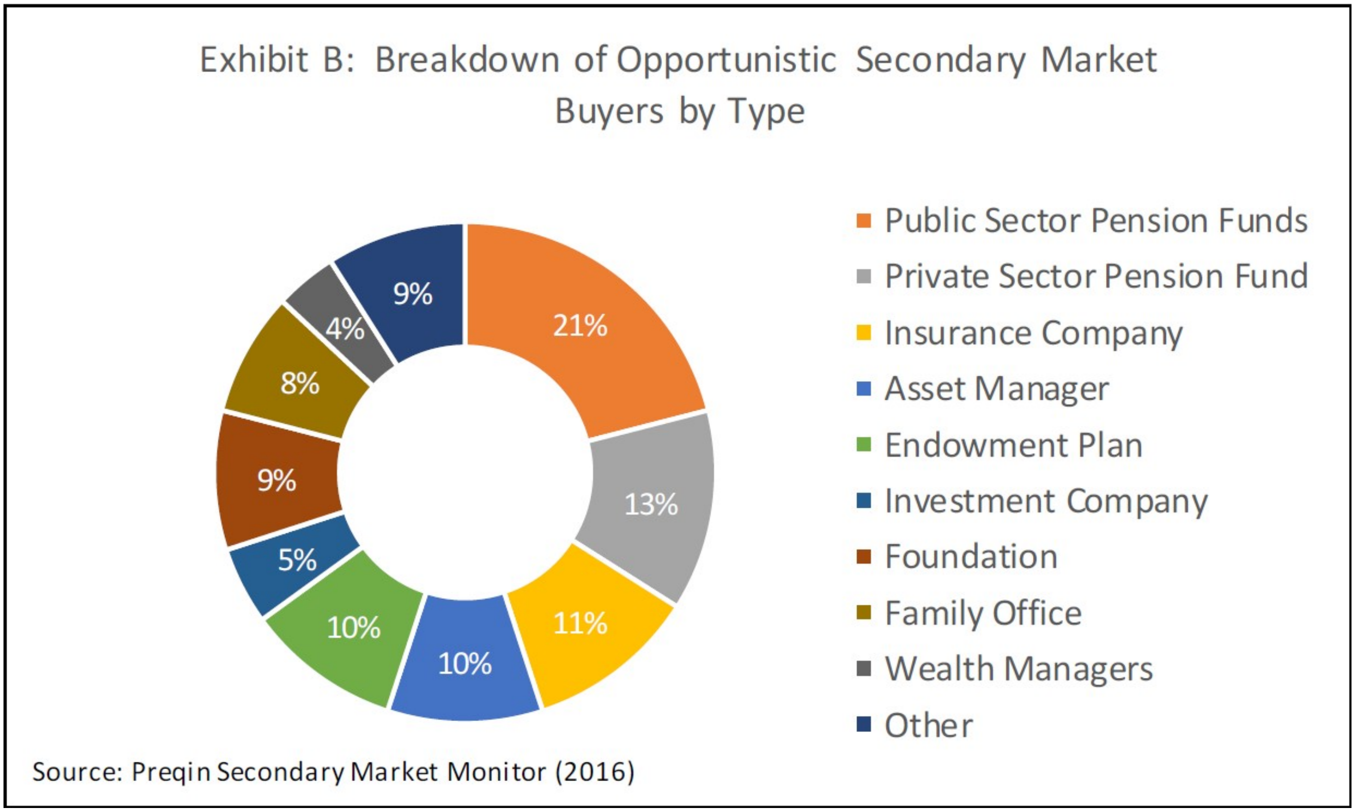


Exhibit B: Breakdown of Opportunistic Secondary Market Buyers by Type

Source: Preqin Secondary Market Monitor (2016)

The Case for Investing in Secondaries

Secondary investments are attractive to investors for a number of reasons. First, as existing portfolio(s) (as opposed to blind pools), the underlying investments can be subjected to valuation tools and metrics because of the transparent nature of the secondary portfolio. In other words, a potential investor knows exactly what they are purchasing. The secondary partnership will always feature a shorter life (typically a few years versus a decade or more) with accompanying acceleration of returning cash, thus addressing the undesirable private market J-Curve effect. In addition, many of the upfront costs and related fees associated with the partnership have already been absorbed by the seller of the secondary interest. Thus, from a performance perspective, private market secondary funds have less dispersion (of results), while offering improved downside protection as the likelihood of a total loss is very remote. Finally, secondaries can address deficiencies in prior execution, including vintage year and geographic and sector gaps. Specifically, clients can use secondaries to design a tailored complementary investment to complete an existing private market portfolio.

What Can Go Wrong?

Every investment has attendant risk, and secondaries are no different. It is critical to identify and select a manager that has a demonstrated skill set in valuing portfolios that can be acquired for less than their Net Asset Value. Further, a manager should be able to source opportunities from private networks (also referred to as "off-the-run"), thus avoiding auction processes involving other like-minded managers with similar strategies, because auctions tend to drive acquisition prices in the wrong direction. Additionally, the skilled consultant will analyze the degree to which the manager plans to employ portfolio level leverage, which could increase risk. Fees and fund terms are also an important differentiating consideration and should be carefully evaluated, although the best managers in this space should underwrite opportunities on a net-of-fee basis.

DeMarche and clients must continue to monitor and evaluate the potential for a supply/demand imbalance as more managers and investors enter the space. Although the final numbers are not yet in, it appears likely that secondary transactions could total nearly $40 billion in 2016, per Preqin.

Conclusion – Our View

DeMarche believes that attractive opportunities continue to exist in private market secondaries, a category that remains fragmented and largely inefficient. As mentioned, manager selection remains very critical, with smaller (sized) strategies that leverage an established primary platform favored over stand-alone firms raising multi-billion dollar funds.

Talk to your DeMarche consultant to determine whether secondaries might be a good fit for your portfolio.

Put Research to Work

with the DeMarche Team

Don Lennard
Senior Consultant
(913) 384-4994

Sources Utilized:

- *Bloomberg Barclays Aggregate*
- *Preqin Secondary Market Monitor*