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NEWS & ANALYSIS

How secondaries can turbocharge evergreen PE funds

A focus on secondaries can deliver strong advantages for new open-end private equity funds, writes Nadim Vasanji, a managing director at Northleaf Capital Partners.

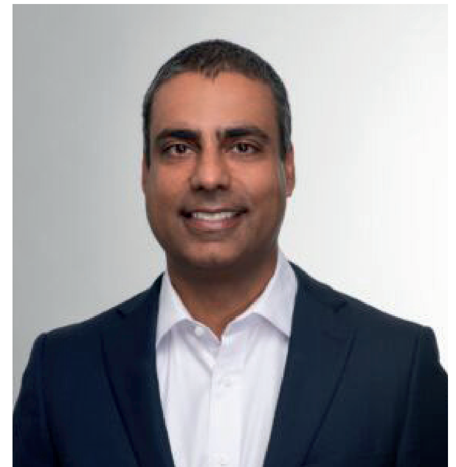
Open-end or evergreen, private equity funds provide investors with several advantages relative to traditional, closed-end structures.

Among these features are enabling investors to quickly ramp up exposure to a private company investment portfolio, diversified across sectors and vintage years, as well as the flexibility to adjust their allocation on a more frequent basis in response to changing portfolio needs.

Open-end funds also provide LPs with simpler administration: they can maintain a target allocation by relying on GPs to recycle proceeds within the structure without the need to be constantly recommitting to new funds and managing bespoke pacing models and off-book, unfunded liabilities.

However, a major challenge associated with creating and launching open-end funds – and the main reason the closed-end variety has historically dominated – is the time it takes for GPs to source, structure and execute the transactions.

One strategy to address this challenge is to use secondaries as the core building block for new open-end private equity funds. An initial focus on secondaries creates a win-win scenario that delivers strong advantages to both GPs and LPs, some of which are detailed below.



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1. Putting money to work quickly

A fund allocating to secondaries can deliver a portfolio of funded assets much more quickly. What's more, secondaries can help to mitigate J-curve risk. For this reason, institutional investors launching a private equity programme have often preferred to emphasise secondaries transactions early on.

2. Diversification

Within two to three years of launch, an evergreen fund focused on secondaries transactions can ramp up to a few hundred underlying private companies. This replicates the diversification that comes from investing in a series of traditional private equity funds in a fraction of the time.

3. Blind pool risk

In traditional private equity funds, the portfolio is constructed post-commitment, which gives little visibility into underlying investments. With secondaries, investors have visibility into mature assets and can therefore better assess the characteristics and quality of a portfolio.

4. Liquidity

Secondaries are able to underpin a liquidity profile that is attractive in the context of an open-end structure. GPs don't need to burden investors with a five- or 10-year lockup because the secondaries provide exposure to more mature buyout companies, typically returning cash to LPs in two and a half to three years.

A diversified fund with secondaries investments will have several hundred companies that vary by vintage, and in any given quarter many of them will be exited, providing a more predictable liquidity profile.

One caveat here for LPs relates to the liquidity terms on offer in an evergreen structure. Well-structured, 'pure-play' evergreen funds will match fund liquidity with the underlying asset mix, which may require a hard lock up. Other approaches may include a liquidity sleeve to provide enhanced liquidity options, although this will typically require an allocation to publicly traded securities, and a potential reduction in the return profile of the fund.

Investors should be wary of liquidity

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promises that a fund may not be able to deliver on should underlying asset liquidity be mismatched. A mismatch can lead to situations where the offered liquidity that LPs are relying upon is unavailable.

5. Managing cash drag

One issue LPs must be cognisant of is the risk of cash drag when an evergreen fund is raising capital on an ongoing basis. Secondaries help to not only address the immediate concern as capital is invested into existing assets, but can also be used to loosen future capital constraints.

Once a fund has built its initial diversification, it can access a growing NAV financing market to put a credit facility in place. High levels of diversification will speed access to and reduce the cost of these facilities.

LPs benefit from a credit facility because, with an evergreen structure, the fund can only bring capital in at the date that it strikes the NAV (usually quarterly). With a credit facility, the fund can continually originate deals and ensure that new inflows repay the facility, rather than sit idle awaiting new deal origination.

The value trap

While the many benefits of leveraging secondaries to build an evergreen fund are compelling, this strategy also comes with a risk when it comes to valuation.

Secondaries create the opportunity to acquire mature private equity assets, often at a discount. In a closed-end fund, all investors will participate equally in that discount. However, in an evergreen fund where investors can come and go, secondaries discounts only benefit incumbent fund investors, as assets are marked to fair value shortly after acquisition.

New LPs in evergreen funds need to make sure that assets acquired in the secondaries market have go-forward (ie, post the impact of any purchase discount) underwritten returns that match the expected return profile. Given this consideration, LPs should prioritise secondaries strategies that emphasise value creation through growth rather than exclusively through discounts.

The strategic use of secondaries makes evergreen private equity funds a much more viable option for LPs by significantly reducing the time required to build a diversified portfolio. While evergreen funds may never achieve the popularity of traditional closed-end funds, the ability to leverage the robust secondaries market will enable more investors to reap the benefits of liquidity, diversification and flexibility that these open-end structures provide.

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