Private Equity Liquidity: A Work in Progress

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The phrase "**private equity liquidity**" once felt like an oxymoron, but the picture is rapidly changing

Liquidity has traditionally meant something very different for private equity than it has for other types of investments. While investors in other vehicles could trade their positions quarterly, monthly, or daily, those in closed-end private equity funds typically agreed to have their capital locked up for a number of years before they saw a return. But as private equity investment vehicles and trading venues advance, that difference is now diminishing.

To gain perspective from industry participants, SEI surveyed 212 private equity managers, investors and consultants in November 2014. The survey was conducted globally and covered topics ranging from the use of the secondary market, perspectives on valuation, the future of listed private equity, and the role of retail funds in what has traditionally been an institutional business.

KEY FINDINGS

Private equity (PE) market participants believe the liquidity of PE investments has increased.

- 47% of general partners (GPs), 36% of limited partners (LPs), and 33% of consultants we surveyed agreed that the market is "more liquid than it used to be."

The growth of the secondary market, fueled in part by rising valuations, has been the biggest contributor to improved liquidity.

- 58% of LPs said they have bought or sold assets on the secondary market.
- A majority of respondents said that selling on the secondary market is no longer taboo, though a large minority said "a little" of that taboo remains.

Views on current secondary market valuation levels varied markedly among types of respondents, and the valuation process was widely viewed as problematic.

- 63% of GPs, 38% of LPs, and 53% of consultants said the market is "fairly valued."
- LPs were the most likely to see the market as overvalued, with 28% of GPs, 54% of LPs, and 32% of consultants agreeing with that view.
- Only one in 10 respondents said the market is undervalued.
- Only 8% said the valuation process is "generally fair and accurate," and four out of five described the quality of valuations as variable.

Listed private equity vehicles are expanding access to liquidity, but expectations are muted.

- A majority of respondents said they expect most private equity firms or funds to remain private despite the trend.
- Only a small share said the trend will gain momentum, with consultants the most bullish.
- Respondents viewed these vehicles as providing different exposure than direct private investments, with 82% saying shares of publicly traded GPs are not a good proxy.

Those we surveyed expressed mixed views of the prospects for retail PE funds.

- A majority said they will remain niche products.
- However, one-third said they will be increasingly important and only a small fraction agreed they "will never amount to much."

Those in the industry believe more liquidity advances are needed, our survey shows.

- Only 22% of GPs, 19% of LPs, and 17% of consultants said liquidity needs are being met by the secondary market and other venues.

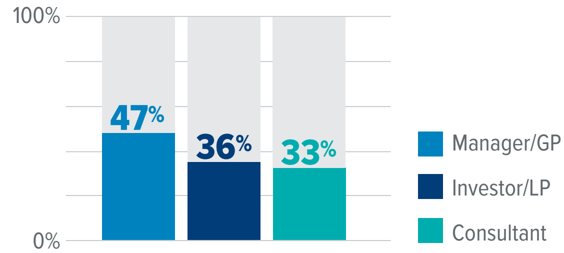
OUR CONCLUSION: The liquidity needs and demands of PE investors will continue to drive the profound transformation that is already underway.

Catalysts for Change

Our survey indicates that private equity investors, particularly GPs, already see liquidity as improved and expect the trend to continue (Figure 1).

- Close to half (47%) of the GPs we surveyed agreed that the private equity market was “more liquid than it used to be” and was likely to “become more so.”
- About one in three LPs and consultants agree that private equity is an increasingly liquid asset class.

FIGURE 1 Which best describes your view of liquidity in the private equity market?



“The PE market is more liquid than it used to be and will continue to become more so.”

Source: 2014 SEI Private Equity Liquidity Survey.

Institutional investors, who have long dominated the private equity arena, have been the primary drivers of change. Beyond pushing for greater liquidity and transparency in alternative investments of all types, institutions have reacted to periods over the past decade when they were stung by greatly reduced deal flow. As they watched some investments languish unsold long past targeted exit dates, many institutions began negotiating for better terms and actively seeking ways to make their private equity allocations more liquid.

Meanwhile, wealthy individual investors in search of higher, more diversified returns have signed up as private equity LPs in growing numbers. They, too, have demanded greater liquidity and transparency. Some managers have recently moved to offer private equity investment options to retail investors, bringing more regulators into play and further intensifying the spotlight on liquidity.

The industry has swiftly adapted to these forces. Once accepted as coming with the territory, private equity’s traditional liquidity constraints are being eased by developments including the growth of the secondary market, expansion in the ranks of publicly traded managers and funds, and the emergence of ‘40 Act funds focused on private equity.

Three Primary Contributors

Liquidity is being injected into the private equity market in three ways, with several variations on each theme (Figure 2). Some of these are still distinctly niche markets, but their combined effect on the private equity industry will be profound, with strategic and operational implications for all parties involved.

FIGURE 2 **Vehicles that are easing liquidity constraints**

Secondary Market	Listed Private Equity	Retail Funds
Direct transfers	Shares of publicly listed GPs/managers	Mutual funds
Brokered transactions	Business development companies (BDCs)	Exchange-traded funds
Trading platforms/exchanges	Funds of funds	Interval funds
Lift outs		
Funds of funds		

Source: SEI.

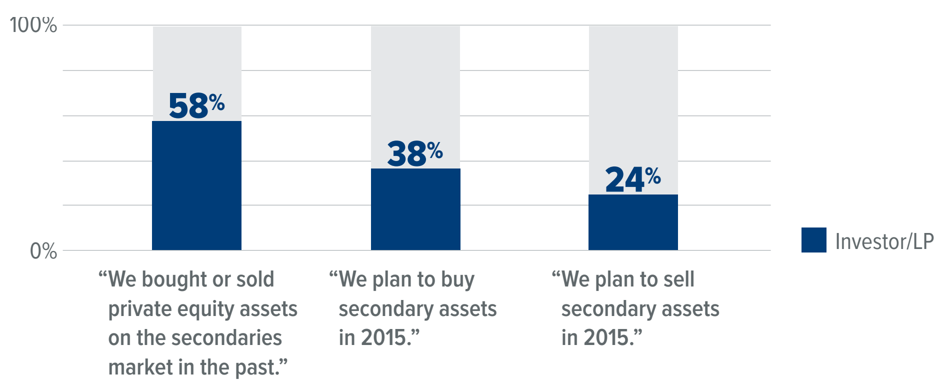
The Secondary Market: A Surge in Activity

The growth of the secondary market has probably had more impact on private equity liquidity than any other development to date. The buying and selling of secondaries was once a niche activity, and one colored by its association with the sale of troubled assets at steep discounts. It is now firmly in the mainstream. The volume of secondary market activity has also grown to record levels, with 2014 global transaction volume expected to surpass $30 billion.[1]

Our survey found that:

- More than half of all investors have bought or sold assets on the secondary market (Figure 3).
- Secondaries play a particularly important role for funds of funds, with 80% using them.
- The foundation and endowment markets are the only investor segment where respondents did not report widespread participation in the secondary market.
- Looking ahead, 38% of all investors surveyed say they plan to buy secondary assets in 2015 and one in four plans to sell assets on the secondary market (Figure 3).

FIGURE 3 **Have you previously used the secondary market or plan to use it in the coming year?**



Source: 2014 SEI Private Equity Liquidity Survey.

[1]Private Equity International, Secondaries Hotting Up, September 2014.

Demand for secondaries remains strong due to the considerable dry powder yet to be deployed. Supply is also healthy, in part because regulatory changes are compelling banks and other financial institutions to divest some holdings.

The surge in secondary market activity can be attributed in part to allocation adjustments by institutional investors. The primary factor, however, has been rising valuations. A report published by Cogent Partners in mid-2014 revealed that average high bids for buyout funds had topped 100% of net asset value (NAV), marking the first time since prior to the financial crisis that any strategy was priced at or above NAV.[2] Not surprisingly, this environment is encouraging more investors to consider selling some of their assets via the secondary market. Higher prices could eventually dampen demand, but that has not yet been the case.

Respondents to our survey voiced varying views on valuation trends (Figure 4):

- The majority of GPs and consultants see the secondary market as fairly valued, an interesting perspective given that deep discounts increasingly appear to be a thing of the past.
- 38% of respondents see the secondary market as currently overvalued. LPs are the most likely to see current price levels as problematic.
- Just one out of 10 survey respondents say the secondary market is undervalued, suggesting improved price discovery as a result of increased activity and transparency.

This lack of consensus is not surprising, given the wide variations in the type and quality of assets, not to mention the lack of uniformity in valuation methodologies. Beyond that, all the parties involved in a transaction bring their own processes and preconceptions to the table.

Respondents did agree, however, that the valuation of secondary assets remains a tricky proposition (Figure 5).

- Only 7% agreed that the valuation process is "generally fair and accurate."
- Consultants are the most likely to find the process "frustratingly opaque."
- More than four out of five concur that the quality of valuations is variable and ultimately hinges on the assets and parties involved. This is not surprising, given the wide array of asset types traded on the secondary market.

FIGURE 4 What is your view of current valuations in the secondary market?

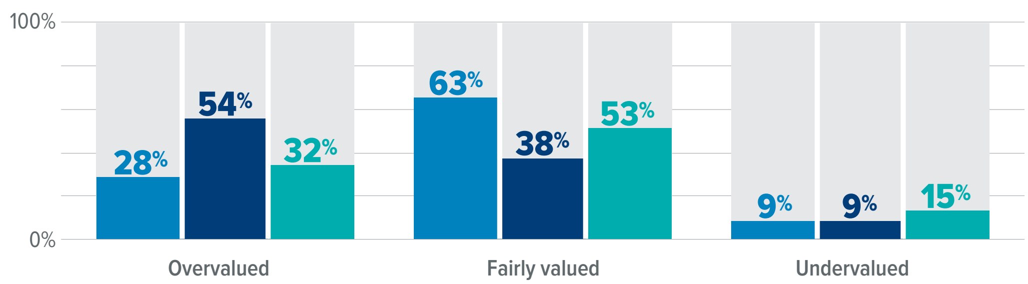
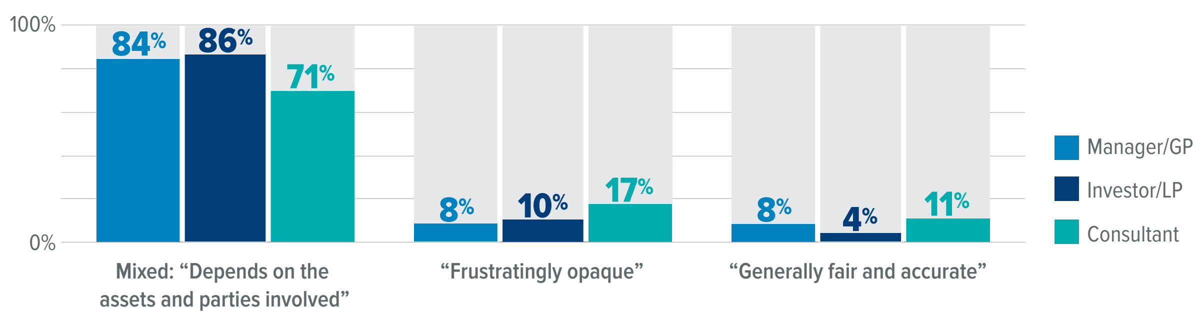


FIGURE 5 Which of these best describes your view of the valuation process for secondaries?



Source: 2014 SEI Private Equity Liquidity Survey.

[2]Cogent Partners, Secondary Market Trends & Outlook, July 2014.

Effectively navigating the secondary market involves analytical talent and effort that may not necessarily be required when buying primary assets, where relationships and manager history carry more weight.

The challenges involved in pricing secondary assets are one reason intermediaries play such an important role in this market. Brokers have been involved in selling secondaries for over a decade, most often in situations where a portfolio of fund interests is being auctioned off. More recently, advisors are helping buyers navigate the secondary market, identify opportunities, conduct due diligence, price assets and execute transactions. The role of buy-side advisors is expected to grow as the universe of secondary market participants continues to expand. The recent growth of a third type of intermediary, dedicated secondary funds and trading platforms, is making the market even more robust.

Our survey findings reflect these trends. Among respondents planning to buy secondaries:

- Nine out of 10 said they expect to do so either directly or with the assistance of a broker.
- More than one out of four plan to invest in a dedicated secondaries fund, while another 13% plan to invest via a platform (Figure 6).
- Of those planning to sell, 41% said they will be selling to dedicated secondary funds (Figure 7).

FIGURE 6 How do you plan to buy secondary assets? (Select all that apply.)

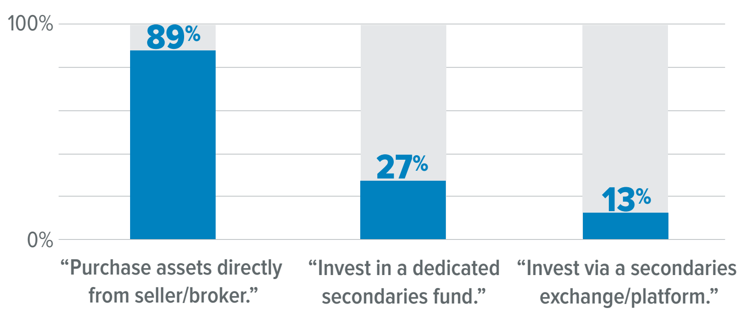
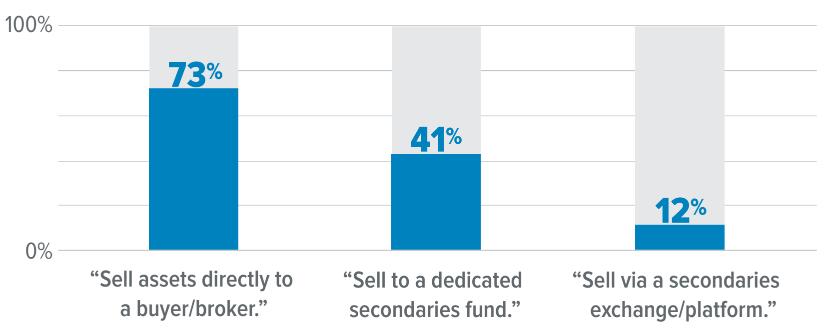
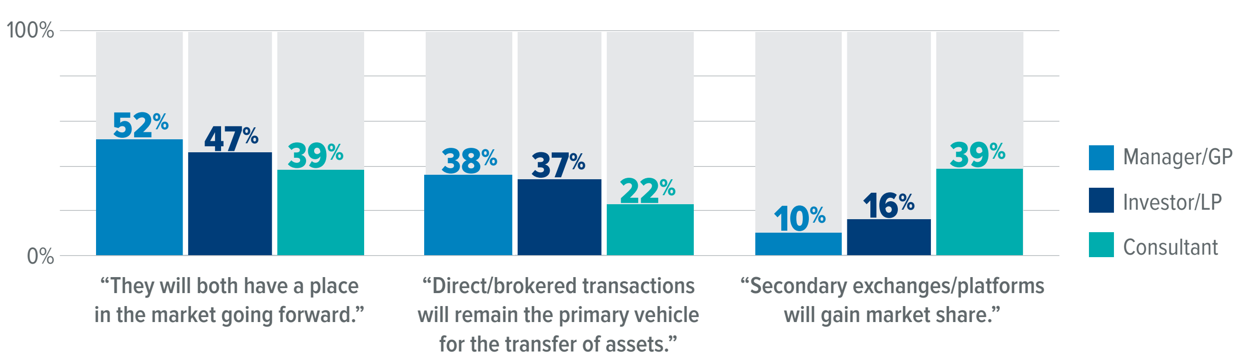


FIGURE 7 How do you plan to sell secondary assets? (Select all that apply.)



Many of those we surveyed said direct and brokered transactions will remain the primary vehicle for transferring secondaries, but they were outnumbered by those who said direct and brokered transactions will co-exist with platforms and exchanges. Consultants were particularly bullish on the prospects of secondary platforms, with 39% predicting they will gain market share, compared to only 10% of GPs (Figure 8).

FIGURE 8 How do you view platforms or exchanges vs. direct or brokered transfer of secondaries?

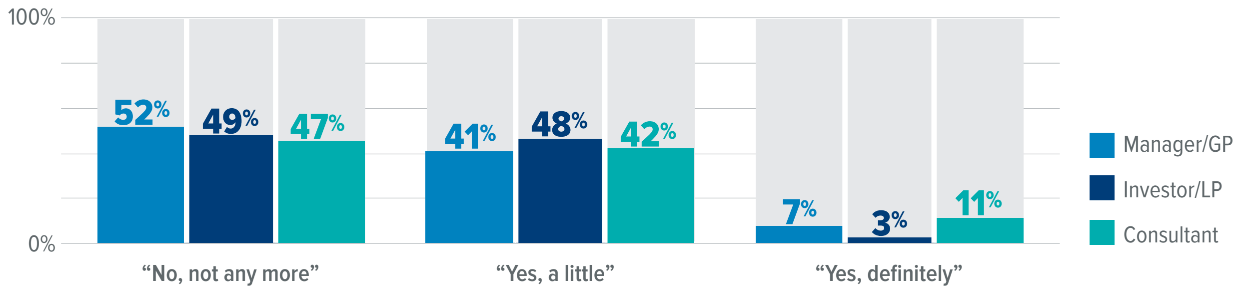


Source: 2014 SEI Private Equity Liquidity Survey.

Secondary market vehicles have clearly made substantial gains in credibility and acceptance since the days when most of such transactions took place on the margins. While 43% of our respondents said "a little" of the old taboo remains, half said it has disappeared entirely (Figure 9).

At this rate, it is not inconceivable that secondary assets will soon serve a similar function to index funds, offering private equity investors the ability to manage volatility, rebalance portfolios, and fine-tune their exposure to the asset class.

FIGURE 9 **Is there any taboo associated with selling on the secondary market?**



Source: 2014 SEI Private Equity Liquidity Survey.

Listed Private Equity: A Vehicle With Many Faces

The increasingly lively secondary market primarily serves institutional investors, but a more recent phenomenon, listed private equity, offers liquidity to any investor with the means to trade on a stock market. The concept of publicly traded private equity has existed for some time in the form of Business Development Companies (BDCs) in the U.S. and Venture Capital Trusts (VCTs) in the U.K. — vehicles that captured widespread attention with some high-profile initial public offerings (IPOs) before the financial crisis.

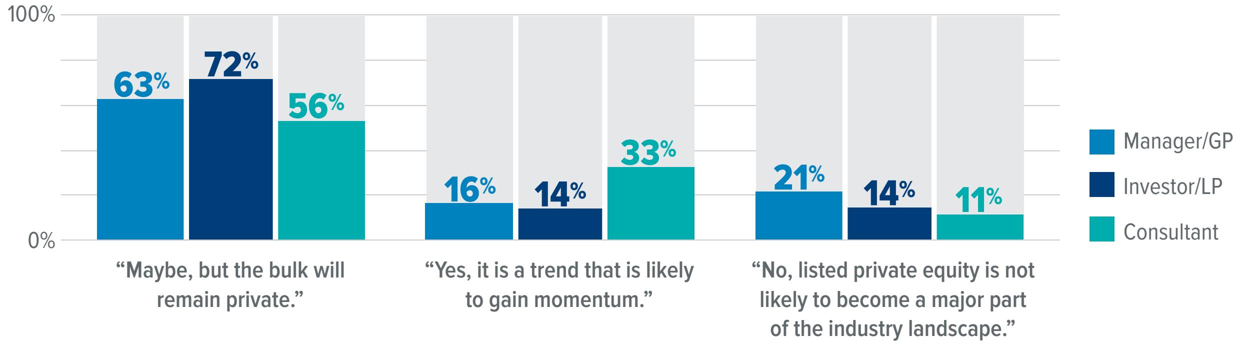
In its simplest form, listed private equity involves a public company that makes direct investments in private firms. There are also listed companies that invest in portfolios of private equity funds. A third permutation involves diversified asset managers that have large private equity holdings and decide to go public.

These types of listed entities are subject to their own trading dynamics. Moreover, they may not always be directly comparable to private equity in the traditional sense, depending on how closely linked the public entity is to its underlying investments. When assets are spread across multiple investments, which may even represent different asset classes, performance characteristics are clearly affected. Indeed, most of our survey respondents agreed that the stock prices of publicly traded private equity firms are not good proxies for private equity investments. The upshot is that investors can gain exposure to private equity by buying shares in listed vehicles, but may sometimes be diluting that exposure in exchange for additional liquidity.

While a wide variety of private equity vehicles are being listed in a growing number of markets around the globe, our survey findings call the trend's momentum into question (Figure 10).

- The consultants we surveyed had the most positive outlook, with one out of three believing the trend would gain momentum.
- The majority of those we surveyed were skeptical, believing that even as more management firms or funds go public, most will remain private.

FIGURE 10 Do you think more PE firms/funds are likely to go public?



Source: 2014 SEI Private Equity Liquidity Survey.

Retail Funds: PE for the Masses?

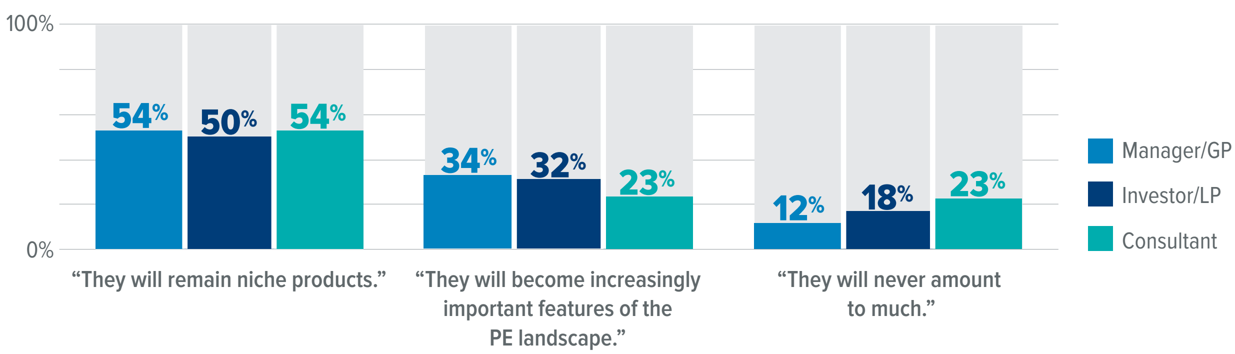
One new development that may accelerate the move toward listed private equity is the introduction of mutual funds and exchange-traded funds (ETFs). These '40 Act funds make private equity broadly accessible in familiar, well-regulated vehicles. It should be noted, however, that these are not necessarily limited to making investments in listed entities. For example, interval funds are able to invest directly in private entities. With monthly (and sometimes more frequent) purchases and quarterly redemptions, interval funds give retail investors the benefits of diversification and price transparency along with a certain level of liquidity.

Private equity mutual funds and ETFs currently account for only a minuscule fraction of total assets. As far as their future prospects are concerned, the opinions of our survey respondents were mixed (Figure 11):

- A majority said they are likely to remain niche products.
- One-third of respondents had the opposite view, saying they expect PE mutual funds and ETFs to become increasingly important.

The meteoric rise of liquid alternatives in recent years suggests there is reason to be optimistic about the future of '40 Act PE funds. While these products may not register prominently on the radars of institutional investors or consultants, they appeal to managers who would like to expand and diversify their client base.

FIGURE 11 What do you think of private equity mutual funds, closed-end funds, and ETFs?



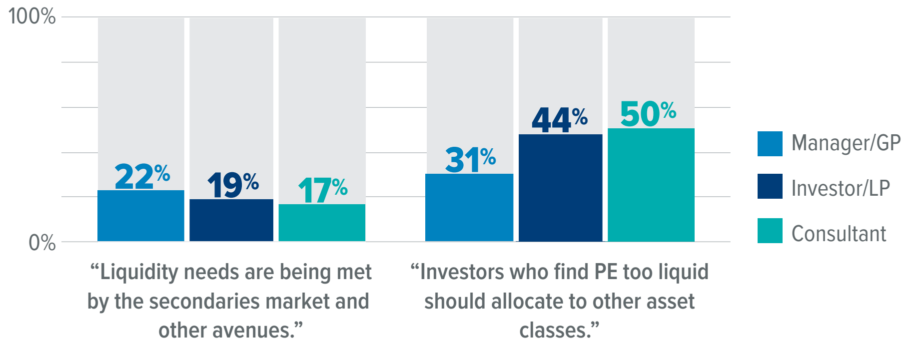
Source: 2014 SEI Private Equity Liquidity Survey.

More Progress Ahead?

While all three groups in our survey saw private equity liquidity as improved, they also agreed that the problem has not been erased (Figure 12).

- Only a modest fraction said liquidity needs are being met by available venues.
- A significant share agreed that investors finding PE too illiquid should allocate to other asset classes, with consultants most likely to hold this view.

FIGURE 12 Which best describes your view of liquidity in the private equity market?



Source: 2014 SEI Private Equity Liquidity Survey.

A Time of Reinvention

Industry veterans may question the utility or even the desirability of some of the private equity vehicles that have emerged in recent years. But that does not negate the direction or the strength of liquidity trends. Converging market forces have triggered a profound transformation that is still unfolding. We are now in an experimental phase in which the private equity industry is being reinvented in real time.

Not all of the new approaches outlined here will succeed, but some will, and benefits could accrue to all market participants. Investors will be better able to manage their private equity portfolios. Sellers will have more options for liquidating positions or adjusting holdings, whether due to regulatory factors or for other reasons. Buyers, for their part, will be able to put their money to work more quickly than they have in the past.

As with all types of disruption and experimentation, serious hurdles remain, and new obstacles are bound to crop up. GPs and asset managers looking to enter the fray will face an array of challenges, such as making pricing more transparent and giving investors more confidence that valuations are fair and accurate.

To be successful, managers must also make sure they have the kind of operating partners and infrastructure the changing private equity environment will require. Managers will need operating capabilities that are sophisticated and flexible enough to handle emerging investment vehicles, work in both on- and off-shore environments, bring greater efficiency to compliance functions, deliver essential tax support, use data management effectively, and meet investors' escalating reporting and client-service demands. Operational requirements will be particularly complex for global public firms conducting business in multiple jurisdictions.

As the ranks of competitors grow, demonstrable expertise and transparency will be the critical differentiators. Thus, the most forward-looking firms will make strategic use of technology, develop strong relationships with their operating partners, and aim to address opportunities globally. In doing so, they will be offering investors something they might not have dreamed possible just a short time ago: meaningful private equity exposure with a high degree of liquidity.

Appendix: Survey Universe

SEI surveyed 212 private equity professionals during November 2014 to gain their perspectives on liquidity in their industry. Approximately half of all responses came from GPs and fund managers. Another one out of three responses came from LPs or investors, with the remainder coming from consultants (Figure 13). A wide variety of institutional investors were surveyed, including funds of funds, family offices, retirement plans, and others (Figure 14). The survey was conducted globally, with 57% of respondents coming from North America, another 25% from Europe, 9% from Asia, and the remainder from Latin America, Australia, and Africa (Figure 15).

FIGURE 13 Survey respondents by type of firm

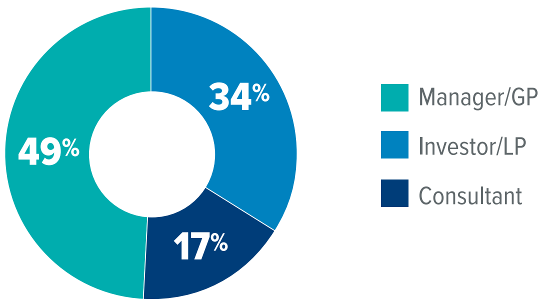


FIGURE 14 Investors/LPs by type

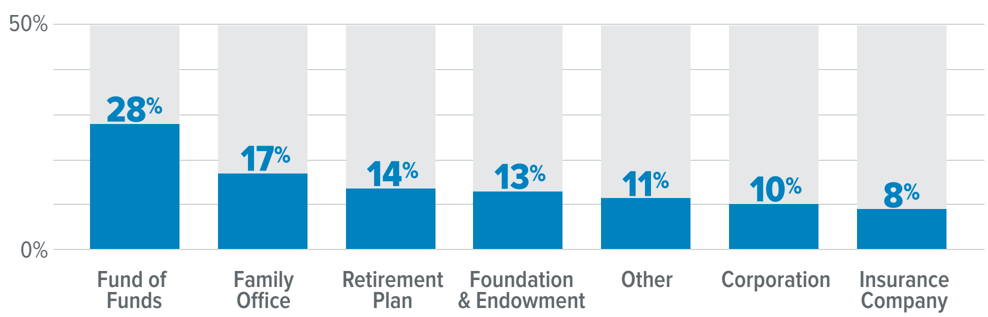
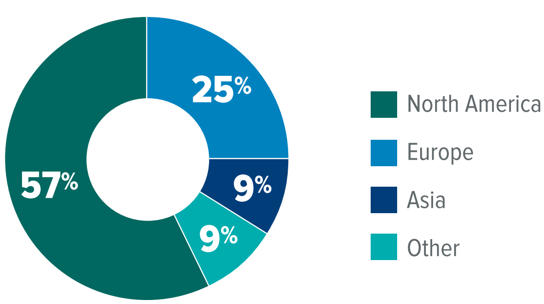


FIGURE 15 Survey respondents by geography



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